The political economy of financial regulation of US investment banking

TREES, HANS

Cover page

Hans Trees

Doctor of Philosophy

School of Government & International Affairs, Durham University

Castle College, Durham University

Hans Trees

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This thesis analyses the political economy of the financial regulation of US investment banking, which is an under-researched topic within the IPE of finance. Various academics claim investment banks – or “Wall Street” – have significant influence on regulatory decision-making as well as policy making more generally so that they can shape the outcomes to suit their preferences. As this thesis will show, the vast majority of these claims are not rooted in empirics. The dissertation examines the factors and circumstances that led to a de-regulatory outcome in the area of financial regulation of investment banking. Five case studies are analysed in this regard: the repeal of the Glass Steagall Act, which is split into three case studies given the length of the period of observation and complexity involved, the Commodity Futures Modernisation Act, which legalised the non-regulation of OTC derivatives markets in the USA, and the Securities and Exchange Commission’s alternative net capital rule regime and Consolidated Supervised Entities Programme. The author tests to what extent interest group based explanation, the role of ideas, the judiciary as well as regulators’ statutory authority played a role in arriving at deregulation. The thesis’s case studies span a period of fourty years.

When analysing the cases, the thesis finds that investment banks’ interest groups were important in providing regulators with information, however the role of the judiciary in interpreting existing laws and thereby given them a different meaning carried as much weight in deregulatory policy outcomes as the aspect of regulators’ own regulatory amendments. Generally speaking, absent legislative change, regulators were successful in achieving their policy outcomes if they were largely aligned with the ideational consensus of the regulatory and market community and acted within their statutory authority. Regulators failed when they acted within their authority, but went against the ideational consensus of the entire regulatory and market community. The thesis shows that these episodes of de-regulation were in fact not driven by “Wall Street” and its lobbyists, but the result of complex chains of causalities in which the judiciary and regulators played major roles.

The political economy of financial regulation of US investment banking

An analysis of key deregulatory decisions

Hans Trees

Doctor of Philosophy

Research conducted at the School of Government and International Affairs, Durham University, Castle College & The London School of Economics and Political Science

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Abbreviations:

ABA: American Bankers Association
BAC: Banking Advisory Committee of the EU
BCBS: Basel Committee on Banking Supervision
BHC: Bank Holding Company
CEA: Commodity Exchange Act of 1936
CFMA: Commodity Futures Modernisation Act of 2000
CFTC: U.S. Commodity Futures Trading Commission
CSE: SEC's Consolidated Supervision Entity Programme
EC: European Community
ECJ: European Court of Justice
ECOFIN: Economic and Finance Council
EU: European Union
Exchange Act: Securities Exchange Act of 1934
Fed: Federal Reserve System
FRB: Federal Reserve Board (Board of Governors of the Federal Reserve)
FSA: The United Kingdom's Financial Services Authority
FSAP: Financial Services Action Plan of the European Commission
GLB: Gramm Leach Bliley Act
ICI: Investment Company Institute
IIF: International Institute of Finance
IOSCO: International Organization of Securities Commissions
IPE: International Political Economy
ISD: Investment Services Directive
LBHI: Lehman Brothers Holding Inc.
LTCM: Long Term Capital Management
NRSO: Nationally Recognised Statistical Rating Organisation
OTC: Over the counter
PWG: The President's Working Group on Financial Markets
ScA: Scenario Analysis
SEC: US Securities and Exchange Commission
SIBHC: Supervised Investment Bank Holding Companies
S&P: Standard & Poor's
TBSCI: The Bear Stearns Holding Company Inc.
US GAAP: United States of America Generally Accepted Accounting Pratices
VaR: Value at Risk

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Dedication

I dedicate this thesis to my loving wife, Maneesha, who endured long nights and weekends of me being locked away doing research without a word of complaint. Without her heart, dedication and love, I would not have been able to finish this work. Thank you. I also wish to dedicate this dissertation to my parents, who have made me the person I am today and have always been there. Thank you both.

Chapter 1

INTRODUCTION

Claims about the power of 'Wall Street' in academia as well as the media range from there being a 'Wall Street Treasury Complex' - that can somehow by virtue of a 'revolving door' between the US Treasury and Wall Street exert influence and shape policy decisions (Bhagwati, 1998) – to investment banks 'requesting' their regulators, in this case the SEC, to use their own internal model for capital adequacies purposes (Johnson & Kwak, 2010). On the subject of the repeal of Glass Steagall, scholars argue that 'Wall Street' lobbied for its repeal (Underhill & Zhang, 2008). The overall message about the 'Wall Street' is clear in all three cases: Wall Street is a powerful lobby whose requests get granted and which enjoys privileged access to the world's key decision-makers. Moreover, claims are made, as in the cases above, that Wall Street lobbied successfully for de-regulation, be this the repeal of Glass Steagall or the Securities Exchange Commission alternative net capital rule regime (Helleiner, 2011).

When one tries to examine the empirical backup for these relatively big claims about the power of Wall Street, one is confronted with the fact that in the vast majority of cases, the authors fail to present an empirical fact base upon which they developed their arguments. Worse, as the literature review of this thesis shows, a great deal of prominent literature in the international political economy (IPE) of finance has become a self referencing body of work whose ultimate empirical foundations rest on here-say and sometimes lack any empirics.

The author, who has been a former practitioner in investment banking, has been puzzled by these claims and lack of data. Overall, no research programme about the workings and influence of investment banking exists today in IPE. This is in contrast to the IPE of commercial banking literature which spans a great many books, journal articles and lively academic as well as public debates. Commercial banking, however, is a very different industry from investment banking: commercial banks are deposit taking organisation that create money via the so-called maturity transformation i.e. investing short-term customer deposits into longer-term loans and mortgages. Because commercial banks do not have to hold one unit of capital for each unit they loan out, they can also create money via this leverage process. Commercial banks technically solvent under the Basel II capital accord if their total capital ratio is no lower than 8% of risk-weighted assets. Without going into great detail about Basel II in this chapter, commercial banks could thus give out $12 worth of loans with only $1 of capital. As such, commercial banks never hold enough reserves to pay out all its depositors in case these wanted all their money back at once – a scenario that is defined as a bank-run and typically triggered by a significant deterioration of trust in the commercial bank's solvency. A commercial bank's solvency is thus the single most important criterion to ensure its operation and it is the ratio sine qua non that banking regulators monitor.

Investment banks, by contrast, are very different businesses. They do not take customer deposits and transform their maturity in order to give out loans and create money. In US legal terms, investment banks are referred to as "inter-broker dealers", which highlights what it is that investment banks actually are: they are brokers which use customer funds to invest or deal on their behalf and not on behalf of the investment bank. Absent any maturity transformation and money creation, investment banking regulators are not focussed on solvency ratios, but liquidity. In case of trouble, investment banks need to be in a position to pay their customers' funds back – which separate from the banks' funds and were thus not used for re-investing into longer term loans or mortgages.

As the literature review shows, the IPE literature on investment banking is extremely limited and the vast majority of IPE research has been done on commercial banking and the Basel Capital Accords, which is a body of academic work that does not apply to investment banks. The thesis seeks fill this gap and to build up a more coherent, empirically backed understanding of the political economy of financial regulation of US investment banking. In doing so, the research puzzle was to understand which factors and circumstances led to specific cases of de-regulatory outcomes. De-regulation can be taken to mean a number of different things: for example, a regulatory decision that led to a reduction in the net capital investment banks have to hold, a legislative Act of US Congress that repeals the separation of investment banking from commercial banking (USA Congress, 1999) or the intentional non-regulation of over the counter (OTC) derivatives markets in the US (USA Congress, 2000).

The thesis follows a qualitative small N case study design and selected three instances of significant de-regulation: the repeal of Glass Steagall, the SEC's Consolidated Supervised Entities Programme and the Commodity Futures Modernisation Act. The thesis examines these three major de-regulatory instances in five distinct case studies. The repeal of the Glass Steagall Act from 1933 that culminated with the passing of the Gramm Leach Bliley Act in 1999 was divided into three chronological parts, each of which has a distinct story to tell.

With the help of the process tracing method, each case study is being analysed to fully unearth the chain of causalities that caused the de-regulatory decision. The author analysed a vast number of primary sources, such as court orders, testimonies in Congress, acts of legislation as well as comment pieces from market participants during the consultation period for proposed rules. In addition, the author conducted nearly forty semi-structured elite interviews covering the world's top regulators, investment bankers, lobbyists and lawyers. As the research design chapter shows, six hypotheses were developed and have been applied in each case study so as to test which explanatory variable is linked to the dependent variable: a reduction in regulation.

The complexities behind each of the case studies deregulatory outcomes does not fit the picture of Wall Street being a powerful actor that can successfully lobby for these outcomes. To the contrary, each of the case studies shows that it is actually not US investment banks who brought about or asked for regulatory change.

The thesis hopes to make important contributions to the IPE scholarship in general and the IPE of investment banking in particular. The concept that you can have significant regulatory change without corresponding legislative change is one of the dissertation's novel contributions. The thesis's case studies on the repeal of Glass Steagall found one actor that has largely been ignored in the IPE of finance: the judiciary. A ruling by the US Supreme Court provided a re-interpretation of the legislative intent of the Glass Steagall Act that considerably changed the separating line between investment and commercial banking and subsequently allowed the

Federal Reserve to gradually authorise Bank Holding Companies' re-entry into investment banking (Supreme Court of the United States, 1981).

A second novel contribution is the concept of regulators' statutory authority. As the case studies on the Commodity Futures Trading Commission (CFTC) and the SEC's Consolidated Supervised Entity (CSE) Programme highlight is the importance of regulators statutory authority in connection with a broad ideational consensus amongst key policymakers and market participants. Whilst the CFTC had statutory authority to exempt OTC derivatives market from CFTC regulation, it nevertheless ended up losing its Chairperson Brooksley Born and being completely isolated amongst key decision-makers. To the contrary, the SEC lacked statutory authority to enforce the CSE Programme for US investment banks, but nevertheless succeeded in establishing it on a voluntary basis as it could build on broad ideational consensus.

Overall, the case studies seek to paint a nuanced picture of the complexities behind deregulatory decision-making, which in all instances – despite the commonly held beliefs about Wall Street in academia – were not driven by investment banks and in some instances were actually to the detriment of investment banks.

The thesis chose these three major de-regulatory events as they build a chronological picture of the political economy of the financial regulation of US investment banking starting in the early 1970s and ending in 2004.

The thesis is outlined as follows:

Chapter 2 provides an extensive literature review that spans from the core writings in the IPE of finance, including the Basel Capital Accords, provides a critical review of pieces focussing on 'Wall Street' and discusses the central weaknesses and gaps in the current research horizon.

Chapter 3 is the thesis's research design and theory chapter. It introduces the thesis research design, namely the qualitative case study method, and research puzzle and discusses the hypotheses and dependent as well as explanatory variables.

Chapters 4 to 6 examine the repeal of the Glass Steagall Act. Chapter 4 traces the beginning of the Act's repeal to a US court decision in the 1960s and highlights how the US Supreme Court set the ball rolling with its landmark interpretative ruling on the Glass Steagall Act in 1981. Chapter 5 analyses the Fed's application of this interpretative ruling under the Chairmanship of Paul Volcker and highlights how the Fed is using its statutory authority to bring about regulatory change without legislative change. Chapter 6 concludes the analysis of Glass Steagall's repeal. It analyses how Alan Greenspan put his mark on the Fed and aggressively pursued regulatory change by way of its statutory authority so that by 1996, entire investment banks could have been acquired by Bank Holding Companies despite Glass Steagall still being in place.

Chapter 7 examines the reasons behind the US Commodities Futures Modernisation Act which legally excluded large parts of US over-the-counter (OTC) derivative markets from regulation. The Act was a direct response to the US Commodity and Futures Trading Commission's (CFTC) concept release under Chairperson Brooksely Born which threatened to classify billions of US dollars worth of OTC instruments as on-exchange futures thus rendering them illegal.

Chapter 8 provides a detailed analysis of the reasons behind the US Securities and Exchange Commission's (SEC) alternative net capital rule and Consolidated Supervised Entity Programme (CSE). Because of the establishment of a single European capital market as envisaged by the European Commissions's Financial Services Action Plan (FSAP), all financial conglomerates active in the EU had to be subject to consolidated supervision – a regime that the SEC did not offer and which subsequently led to the establishment of the alternative net capital rule and the CSE Programme.

Chapter 9 provides conclusions and a high level case study comparison and identifies common elements that brought about similar regulatory outcomes.

Chapter 2

THEORIES OF REGULATORY DECISION-MAKING IN THE IPE OF FINANCE LITERATURE

2.1 INTRODUCTION

This chapter (i) sets out the current scholarly debate and theories in the international political economy (IPE) of finance, (ii) highlights how the debate links up with the political economy of investment banking and (iii) examines the literature's shortcomings. The chapter's first section introduces the main theories of regulatory decision-making in political science and economics relevant to IPE. Section two analyses how these theories of regulation translate into writings in the field of the political economy of finance, especially financial regulation, banking and financial crises. Here, the section focuses on how these IPE texts relate to the IPE of investment banking and where these current writings bear shortcomings.

2.2 THEORIES OF REGULATION AND THE STUDY OF INTERNATIONAL POLITICAL ECONOMY OF FINANCE

A whole spectrum of theories explaining regulatory decision-making in the context of IPE exists, but, oddly, claims made about the influence and/or 'power' of interest groups representing financial institutions have not sufficiently – sometimes at all – been supported with empirical data.[1] Moreover, only a limited amount of works

[1] For example, Wade and Veneroso (Wade, R. H. and F. Veneroso (1998). "The Asian Crisis: The High Debt Model versus the Wall Street-Treasury IMF complex." New Left Review **228**(228).) claim that a 'Wall Street-Treasury Complex' exists through which Wall Street exerts considerable power over US policymaking including, but not limited to, the IMF response to the Asian Financial Crisis of 1997/98. Wade and Veneroso fail, however, to provide any empirical support for their claims. The authors take the notion of a 'Wall Street-Treasury Complex' from an article by Bhagwati in Foreign Affairs (Bhagwati, J. (1998). "The Capital Myth." Foreign Affairs **77**(3): 7-12.). Bhagwati, too, fails to back up his arguments with data. Helleiner and Clapp (Clapp, J. and E. Helleiner (2010). "Troubled futures? The global food crisis and the politics of agricultural derivatives regulation." Review of International Political Economy.) built on the concept of the Wall Street Treasury Complex idea without providing any empirical evidence besides two articles from the online source *Huffington Post* (Grim, R. (2009). Truckers, Farmers, Airlines Battle Wall Street. The Huffington Post. and Grim, R. (2010). Wall Street Reform: Traditional Foes Join Forces to Take on Bankers. The Huffington Post .) Furthermore, it is striking that Helleiner includes the book *13 Bankers* (Johnson, S. and J. Kwak (2010). 13 bankers : the

assesses the role and importance of investment banking, even though the power and influence of investment banks or ‘Wall Street’ on regulatory decision-making and in the financial community has been a hotly debated topic for more than a century.[2] The introductory chapter highlighted the stark differences between commercial banks and investment banks. The vast body of IPE research and literature on commercial banking and the Basel capital accords is thus not applicable to the IPE of investment banking. As a result, the claims and arguments that are made about investment banking within the commercial banking literature often stand without practical application and empirical backup.

This thesis thus makes an important contribution in establishing the IPE of investment banking as a distinct body of research from the wider IPE of commercial banking literature. The starting point for framing such an analysis of the political economy of investment banking is the IPE of finance literature. Here, two large streams of inquiry emerge:

Firstly, works on the IPE of banking and the Basel accords, which in turn build upon theories of financial regulation;

Secondly, IPE literature about financial crises and capital account liberalisation, which covers the influence of ‘Wall Street’.

It may seem strange to take this diversion, i.e. analysing the political economy of investment banking through situating it in the wider political economy of finance literature rather than directly focusing on investment banking. However, the thesis shows that it is necessary to do so for two major reasons:

Firstly, many IPE researchers incorrectly regard investment banking as part of commercial banking, even though these two businesses are in fact totally distinct activities. Classical investment banking is a non-deposit taking financial activity,

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Wall Street takeover and the next financial meltdown. New York, Random House.) as a scholarly text in IPE in his review article about the global financial crisis (Helleiner, E. (2011). "Understanding the 2007-2008 Global Financial Crisis: Lessons for Scholars of International Political Economy." Annual Review of Political Science **14**(1): 67-87.). *13 Bankers* makes sweeping statements about the power and influence of Wall Street, but provides little empirical backup other than public media sources.

[2] For a detailed academic discussion on the history of US investment banking covering the public sentiment against the industry in the early 20th century, including the allegation of John Pierpont Morgan running a ‘money trust’, see Vincent Carosso’s definitive account *Investment Banking in America: a history* (Carosso, V. P., M. V. Sears and I. Katz (1970). Investment banking in America : a history. Cambridge (Mass.)
London, Harvard U.P..)

whereby the investment banks – the agents – act on behalf of their clients – the principals – to trade in equity and debt capital markets. In other words, they are inter-broker dealers of their principals' money. Investment banks finance and re-finance their liquidity through tapping banking wholesale markets, often on an overnight basis via repurchase agreements. Other investment banking operations such as corporate finance advisory and equity and debt research require little capital and also take no customer deposits. In the absence of any maturity transformation that commercial and retail banks do on a daily basis with customer funds – such as using short-term customer savings to make long-term mortgages – and investment banks can be, and indeed were, liquidated within days.[3] The literature on the IPE of banking and the Basel accords touches upon security market activities and investment banking, as the chapter will discuss below. Nonetheless, most IPE texts either fail to address the big questions, e.g. why do we not have an international capital accord for investment banking, have factual inaccuracies or simply ignore investment banking altogether.

Secondly, and possibly as a result of the first point, the IPE of finance literature has currently no works exclusively on the IPE of investment banking[4]. The overwhelming majority of scholarly pieces focus on the role of commercial banking and the Basel capital accords. A second strand, the IPE of financial crises literature, discusses 'Wall Street' - a term used synonymously as investment banking, yet often mixed up to also refer to commercial banking - but often fails to provide empirical validation for the arguments made. The paragraphs that follow review the various IPE scholars that claim lobby group pressure played a significant part in Washington, especially during financial crises, yet give little detail as to how this pressure was exerted, when and if at all. Often, the mere fact that an investment banker left Wall Street to serve the public instead is taken as *the* proof of Wall Street's influence on Capitol Hill. Worse, even the 'biggest' names in IPE appear to have little knowledge about how investment banks work and what regulation is imposed on them. The IPE of investment banking is an area that is both distinct from the IPE of commercial banking and as such in need of a detailed and empirically sound and independent body of literature and research programmes.

[3] The US investment bank Drexel Lambert Burnham filed for bankruptcy in February 1992 and was liquidated without causing market disturbance.
[4] Last checked September 2016

2.2.1 The Concept Of Regulation And Regulatory Theories

Financial regulation is a complex topic encompassing political, financial, social and legal dimensions. When thinking about the *concept* of regulation more generally, different definitions emerge depending on the academic discipline. The *Penguin Dictionary of Economics* defines regulation as “the supervision and control of the economic activities of private enterprise by government in the interest of economic efficiency, fairness, health and safety” (Bannock, Davis et al. 1998, p.353). By contrast, the *Oxford Concise Dictionary of Politics* states that regulation is defined “in its specialised political sense, the control of privately owned monopoly by government rules […] ‘Regulation’ is also used more broadly to cover any publicly imposed rules governing a firm or industry” (McLean and McMillan 2003, p.459). Scholars of finance define the regulators’ tasks as “first, to ensure that markets work efficiently by managing systemic risk and by preventing market abuse and economic crime; second, protecting the consumer” (Eatwell and Taylor 2000, p.19). Baldwin and Cave differentiate between ‘different senses’ of the meaning of regulation (Baldwin and Cave 1999). They have a threefold understanding:

First, “as a specific set of commands – where regulation involves the promulgation of a binding set of rules to be applied by a body devoted to this purpose” (ibid, p.2);

Second, “as deliberate state influence – where regulation has a more broad sense and covers all state actions designed to influence industrial or social behaviour” (ibid, p.2);

Lastly, “as all forms of social control or influence – where all mechanisms affecting behaviour - whether these be state-derived or from other sources (e.g. markets) – are deemed regulatory” (ibid, p.2).

Looking more specifically at *financial* regulation, academics and policy-makers distinguish between regulation (i.e. setting rules of behaviour or prudential standards), monitoring (observing whether these rules are obeyed / conduct of business), and supervision (more general observation of actors' behaviour). Financial regulation by itself covers a wide array of areas ranging from bank capital requirements, insider dealing legislation, controls on money laundering, rules on investor protection to setting accounting standards (Llewellyn 1999). The basic economic rationale for financial regulation is to manage the externalities that financial market activity generates which private sector actors cannot easily address. These externalities include, inter alia, systemic risks (which private actors either do not price in or calculate incorrectly in the case of sub-prime mortgages) and information asymmetries (which is a core principle and motif in the markets for making money). Regulatory intervention becomes necessary if regulation is seen as a free good that changes the behaviour of the regulated entities (in this case financial institutions) so as to strike a balance between the effective operation of free markets (and the creative powers of risk-taking) whilst maintaining the system's overall soundness and correcting potential market imperfections (Davies and Green 2008). Different regulators hold varying ideas as to what the 'optimal' balance of regulation is, as it imposes costs on its regulated entities (which are often passed on to consumers). Generally speaking, regulation can only be justified if the benefits exceed the costs imposed. However, such cost benefit evaluations remain premature up until today (Davies and Green 2008). The costs associated with the current or latest financial crisis of 2007 – 2009 (some might argue that parts of Europe are still in crisis today, nearly ten years later) can be measured in direct and indirect terms. Depending on what source and data is used, these costs vary between more than $4 trillion in expected write-downs by the end of 2011 (IMF 2009) to more moderate calculations of direct fiscal costs of less than 1% of GDP in most developed countries (Deutsche Bank 2010). Given these various definitions of regulation, the thesis takes regulation to mean the publicly exercised control of market activity - either directly or indirectly – by means of laws, statutes and supervision.

As regards the main *theories* of regulation, we can roughly divide these as follows: public interest models, private interest theories, (historical) institutionalist theories, ideas-based approaches and mixed models incorporating elements of all of the above.

Public interest theories assert that regulation identifies and successfully corrects market failures so that publicly desirable outcomes are achieved (Landis 1938).

Regulators are depicted as disinterested, experienced professionals concerned with efficiency and the public good (Cushman 1972). The tradition of 'welfare economics' broadly falls into this category. Critics purport that it is not clear what the public interest actually is, and they question whether regulators are in fact disinterested, efficient and well-trained individuals (Francis 1993). Motives of personal gain, critics argue, may interfere with the public interest, and legislators as well as private interest groups may influence regulatory decision-making and thus 'capture' the regulators.

In line with this criticism, private interest theories assert that regulation is the reflection of private interests made up of rational actors. Stigler (Stigler 1971) and Peltzman (Peltzman 1976) established the 'Chicago Theory of Regulation' which sees regulation as a supply *and* demand side model. They demonstrate how regulation is not simply supplied to markets, but show why and how the industry demands regulation as a way to extract rents, erect barriers to market entry and fix prices. In return for state supplied regulation, the industry "which seeks regulation must be prepared to pay with the two things a party needs: votes and resources" (Stigler 1971, p.12). According to this model, the regulation would thus be favourable to well organised, compact industry interest groups who are better organised and not as diffused as the mass of consumers (Peltzman 1976). Individuals are defined as rational income maximisers. The Chicago School has been criticised for underestimating the role of ideas, problems associated with determining people's regulatory preferences, the ability to act altruistically or irrationally and the theory's failure to provide a more detailed account of the design and adaptability of regulatory institutions.

Historical institutional approaches emphasise the role of institutions (Thatcher 2007), their historical stability and highlight that cross-national differences continue to exist despite common external pressures.[5] Instead of focusing on individuals' preferences, these theories analyse what impact institutional settings and administrative procedures

[5] For an overview of works: Streek and Thelen (eds.) *Beyond continuity: institutional change in advanced political economies* Streeck, W. and K. A. Thelen (2005). Beyond continuity : institutional change in advanced political economies. Oxford, Oxford University Press.; Hall and Soskice (eds.) *Varieties of Capitalism* Hall, P. A. and D. W. Soskice (2001). Varieties of capitalism : the institutional foundations of comparative advantage. Oxford, Oxford University Press..

have on individuals' preferences and how they can shape them. Research ranges from (neo) institutional economics to sociological theories of regulatory capture. Hancké and Herrmann analyse how the rules pertaining to the European Monetary Union have influenced wage bargaining in Euro member countries (Hancké and Herrmann in Hancke, Rhodes et al. 2007). In the same volume of this book, Thatcher examines the reforms of national regulatory institutions for network industries in Europe. He argues that "regulatory institutions offer a powerful means to coordinate firms, governments and public policy-makers, and hence create institutional advantages" (Thatcher in Hancke, Rhodes et al. 2007).

Ideational or constructivist accounts examine the influence of economic paradigms, such as the Efficient Market Hypothesis, on regulatory decision-making. Blyth shows how economic ideas "provided the Swedish state […] with the means to construct the institutions of the Swedish model" in the 1930s and 1940s whilst Swedish businesses used a new set of ideas in the 1980s "to contest and thus delegitimise existing institutions and the patterns of distribution that they made possible, beginning the process of overturning the Swedish model long before capital mobility or domestic inflation was ever a problem" (Blyth 2001, p.2). Other constructivist works look at links between IMF employees' education and IMF policies (Chwieroth 2007), the influence of ideas on American trade policy (Goldstein 1993) or the relationship between policy paradigms and social learning (Hall 1993).

A whole range of mixed models employ elements of all these theories of regulation. An example would be Levi-Faur's work on the global diffusion of regulatory capitalism (Levi-Faur 2005) in which he looks at a whole variety of factors giving rise to the diffusion of regulatory capitalism, such as the relationship between the state and society, the proliferation of new technologies and the importance of epistemic communities amongst others. Even though it can be argued that regulating financial institutions is more difficult than regulating businesses of the real economy – because of the unique and systemically important role financial institutions occupy in any real economy – theories of *financial* regulation essentially derive from the general theories of regulation examined above.

2.3 THE IPE OF FINANCE LITERATURE

This section outlines the current research horizon in the international political economy of finance. The vast majority of research concentrates on two large areas: firstly, the politics of financial regulatory harmonisation – with an overwhelming focus on the Basel accords – and, secondly, on the politics of financial crises and capital account liberalisation. The literature on regulatory harmonisation has little to say about investment banking. The body of works on financial crises and financial liberalisation refers more often to 'Wall Street', but whether the use of this term is justified is doubtful.

2.3.1 Literature On The Basel I Capital Accord

The Basel Capital Accord of 1988, widely known as Basel I, marked a sea change for transnational financial regulatory cooperation. The backdrop to Basel I can ultimately be seen in the breakdown of the Bretton Woods System in 1973 and the years of financial turbulence and stagflation that followed. The rise of modern communication equipment and the increase in capital mobility translated into a renaissance of 'globalisation' in finance. The failure of Cologne-based Bankhaus Herstatt in 1974, probably one of the best-known examples of settlement risk in banking, and the collapse of Franklin National bank in the US caused considerable shock waves in financial markets and amongst politicians. Kapstein asserts that these events were the catalyst for central bankers and governments to start cooperating transnationally in the area of financial regulation. This took the form of policy coordination in supervising internationally active banks and information sharing on bank practices (Kapstein 2006) (Kapstein 1989).

The immediate policy outcome was the *Basel Concordat* (Committee on Banking Regulations and Supervisory Practises 1975) in which it states that the Basel Committee on Banking Regulation and Supervisory Practises "agreed that the basic aim of international cooperation in this field should be to ensure that no foreign banking establishment escapes supervision”, that “each country has a duty to ensure that foreign banking establishments in its territory are supervised” and that for liquidity management and supply both the host country authority “can carry out the continuous supervision of liquidity which may from time to time be required” as well as the home country since “the parent authority, in controlling the liquidity of the parent bank, must take account of calls that its foreign branches might make on its liquid resources” so that “the liquidity of foreign branches is a matter of concern to parent authorities also” (Committee on Banking Regulations and Supervisory Practises 1975, p.1-5). Whilst the Basel Concordat was a first significant step for international regulatory cooperation, its vagueness and non-binding character prevented it from being considerably more than lip service. Basel I changed this. Basel I set minimum levels of capital for internationally active banks and “the framework […] is mainly directed towards assessing capital in relation to credit risk (the risk of counterparty failure) but other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing overall capital adequacy” (Basel Committee on Banking Supervision 1988, p.2). For the first time, Basel I defined what could count as banks’ equity, it set minimum “core” capital standards and established a framework for weighing the riskiness of assets. Each of these weighting and ratios carries potentially enormous regulatory costs and are thus highly political. The target standard ratio (nowadays commonly known as Tier One Capital ratio[6]) is calculated on the basis of a bank’s risk weighted assets, the weighing of which carried huge implications for banks and their customers. These calculations carried enormous re-distributive consequences, i.e. costs, within the banking systems and thus its customers. To illustrate this point further, banks had to set aside considerably less capital on loans to OECD governments (0% risk weighting) than for loans to a private sector company (100% risk weighting).[7] Based on this simple example, it is evident that considerable amounts of capital and ultimately the availability of credit to domestic economies

[6] The Tier One capital ratio is the ratio of a bank’s equity over its risk-weighted assets. Importantly, Basel I defined what counts as ‘equity’ and how to weigh up the bank’s assets according to risk metrics. The Tier One Capital ratio was set at 8% whilst the Core Tier One Ratio, i.e. the equity part of a bank that was only made up of shareholders’ equity and no subordinated debt, was set at 4%.
[7] To illustrate the financial impact of the risk weighting, a \$100m loan to an OECD government did not require any capital charge since it was weighed as 0%. By contrast, a \$100m loan to a private company resulted in a capital charge of \$4m given a 100% weighting of the asset and a minimum requirement to hold 4% as equity on the bank’s books.

were at stake during the Basel negotiations. Risk weightings and capital charges directly fed through into credit availability and pricing. In addition, the structure of banking systems varied considerably between the G10 countries. When applying Basel I to national banking systems, some banking systems were significantly undercapitalised, such as Japan. The benefit of enhanced international financial stability thus came at a cost. The big IPE question is this: why did the G10 governments agree and who had to adjust?

Kaplan argues that “the successful negotiation of a common standard for adequacy of capital by the G-10 countries was due to the development of consensual knowledge regarding systemic risks, combined with decisive leadership on the part of the United States and Great Britain” (Kapstein 1989, p.324). He asserts that this consensual knowledge was a necessary, but not sufficient condition for international regulation. Rather, the pre-Basel I UK-US bilateral agreement on common bank capital adequacy of January 1987 established an ‘economic exclusion zone’ and was thus a “tacit threat of preventing foreign banks from expanding operations or establishing new ones” (Kapstein 1989, p.344). Kapstein changed the emphasis of his argument in a second paper three years later. He still saw structural power aspects behind the Anglo-American bilateral agreement allowing the Americans to pressurise the Japanese whilst giving the British an instrument to fend off European Commission led regulatory efforts (Kapstein 1992). However, he argues “the decision to pursue the idea of a single capital adequacy standard was not so much the product of collective technical knowledge as it was the reflection of what the British and American central bankers considered to be the ‘art of the possible’ given the international and domestic politics in which the debt crisis was embedded” (Kapstein 1992). Oatley and Nabors stylise Kapstein’s work as representative of international cooperation scholars for whom the establishment of international institutions is a functional expression to realise joint gains (Oatley and Nabors 1998). They challenge the functional argument and suggest that Basel I is an expression of rent-seeking, or as they call it “an instance of redistributive cooperation: the creation of an international institution that intentionally reduces at least one other government’s welfare compared to the status quo” (Oatley and Nabors 1998, p.36). American policymakers, Oatley and Nabors argue, were especially concerned with the continuing substantial deterioration in earnings power and market share of the US commercial banking industry, which was primarily a result of considerable domestic (via capital markets) as well as foreign competition (Japanese and continental European universal banks). In response, American policy-makers established the Anglo-American bilateral agreement in January 1987 and used their 'market share' in global finance to alter significantly the choice-set for the remaining G10 governments during the Basel negotiations: the Japanese were the primary targets of this campaign as Japanese banks had low capital adequacy rates by international comparison. Because of Japan's dependence on the US military, and as a result of the Anglo-American threat to close off capital markets to banks not applying their capital standards, Japan joined the bilateral capital adequacy agreement in June 1987. Japan's acceptance laid the path for the multilateral agreement of Basel I (Oatley and Nabors 1998).

2.3.1.1 The Limitations of the Literature on Basel I

The literature on Basel I contributed significantly to our understanding of the reasons behind international cooperation in financial regulation generally, and is an important cornerstone for the development of the IPE of Finance. In particular, Kapstein made several extremely thoughtful points on 'new financial trends' which continue to be of utmost relevance to date: the growing interdependence of banking systems, the rise of financial engineering such as securitisation, the practice of off-balance sheet obligations and the rise in financial speculation. Kapstein presents these trends as the backdrop for the Basel I negotiations.

However, Kapstein's and Oatley and Nabors' accounts, different as they are, focus on American commercial banks and the competitive threat from their Japanese counterparts. Neither of them shed any light on investment banking and the Glass-Steagall Act. Kapstein refers to a statement from the American Bankers Association (ABA) in which the ABA expresses its concerns that the new capital adequacy measures would further undermine US commercial banks' competitiveness vis-à-vis US investment banks.[8] Surprisingly though, he only presents this statement as *another* reason for Basel I rather than a major industry development in its own right. As is set

[8] Statement from the American Bankers Association sent to the Federal Reserve Board on 23 May 1986 and referenced on page 280 in Kapstein 1992.

out in the chapter on the repeal of the Glass-Steagall Act, the American banking industry was deeply dissatisfied with the continuing separation of commercial and investment banking. US banks kept losing significant market shares at home to non-banks in both retail and corporate sectors and investment banks abroad, which caused a significant decline in overall bank profitability. At the time, the deterioration of banks' profitability alarmed regulators – the OCC, the FDIC and the Fed. They, too, argued for a change in legislation that would allow banks to conduct certain insurance and securities activities. In fact, as early as November 1987, the Chairman of the Board of Governors of the Federal Reserve System Alan Greenspan testified before the Subcommittee on Financial Institution Supervision, Regulation and Insurance of the United States House of Representatives:

> …it would be appropriate at this time to concentrate on the specific suggestion to repeal the Glass-Steagall Act. It is our view that this action would respond effectively to the marked changes that have taken place in the financial marketplace here and abroad, and would permit banks to operate in areas where they already have considerable experience and expertise. Moreover, repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk (Greenspan 1987).

It is striking that Kapstein and Oatley and Nabors did not focus on this significant mood-swing amongst US regulators. Academics covered how the Latin America Debt crisis as well as the Basel I Accord fundamentally altered the course of events in finance for the decades to follow. However, the progressive unravelling of the separation between investment banking from commercial (and retail) banking has not been covered despite the fact that it was probably one of the key events, if not the key factor, to change the political economy of financial regulation of the investment banking industry.

2.4 BASEL 1+ LITERATURE

A whole range of authors analyse the Basel I accord alongside other financial regulatory agreements, such as capital markets regulation. Since investment banks are significant, if not the most significant, players on capital markets at the time, one would expect that they naturally play a leading role in any academic analysis of capital market regulation.

2.4.1 Beth Simmons

Beth Simmons examines the mechanisms and processes that drive regulatory harmonisation in global finance. She focuses on Basel I, anti-money laundering, accounting standards for IPOs and information sharing among securities regulators (Simmons 2001). Assuming that only one dominant (or "hegemonic") financial centre exists (i.e. the US and/or the UK[9]), Simmons investigates whether the policies of the dominant financial centre cause negative externalities for all other centres so that these are incentivised to emulate the policies of the dominant centre. As such, if negative externalities are significant and incentives for emulation high, regulatory harmonisation along the lines of the dominant centre's policies follows. Simmons argues that the Basel accords are an example for this. By contrast, information sharing amongst security regulators is a case of insignificant negative externalities and low incentives to emulate. Furthermore, she maintains that the absence of a multilateral solution in this instance is because "bilateral agreements are easier to negotiate than multilateral accords and minimise defection through specific reciprocity" (Simmons 2001, p.612).

2.4.1.1 Simmons's shortcomings

Interestingly, Simmons highlights that there are systemic risks involved in not sharing information, as the collapse of Barings Bank demonstrated. She also concedes that this actually raises doubts as to whether information sharing has low negative externalities and low incentives. It is thus odd that Simmons chose this case; it does not fit her matrix, as the absence of information sharing carries enormous negative

[9] After a long discussion of financial markets statistics, Simmons concludes that "regulators in the United States and the United Kingdom exercise jurisdiction over financial institutions and networks that are strategically important to the global financial system as a whole" (Simmons, 2001, p.594) Simmons, B. A. (2001). "The international politics of harmonisation: the case of capital market regulation." International Organization **55**(3): 589-620.

externalities. Moreover, it constitutes a very specific case within security regulation that fails to address the bigger question: why is there no international capital adequacy standard for investment banks? Her paper displays many analytical weaknesses, not least her uncritical celebration of Anglo-American 'best practices' in supervision and regulation (ibid, p.594). She argues that the Pound Sterling has a special role in international trade and FDI even though the UK lags far behind the export powerhouses of Japan and Germany. Simmons's analysis of the matrix and her chosen issue areas have proven problematic in all quadrants. To give just one example, Simmons assumes that US accounting standards for IPOs carry high incentives for emulation without having significant negative externalities. The opposite happened after the Enron and Worldcom scandals and the Sarbanes-Oxley Act that Congress passed thereafter. The tightening of accounting and corporate governance standards in the US led to a significant shift of IPOs away from the US towards Europe, especially London and Amsterdam.

Drezner criticises Simmons's study for incorrectly assuming that the US is a hegemonic power in finance (Drezner 2007). He contends that both the EU and the US dominate global finance and provide financial regulation via international government organisations, such as the Basel Committee and the Financial Action Task Force, as club goods. He emphasises that "the great powers, as developed economies, derived significant benefits from coordination at a stringent level of regulation" and that "the distributional implications among these states are small" (Drezner 2007, p.122) . The power differential is therefore not within the developed country world, but between developing and developed countries.

2.4.2 David Singer

Probably by now one of the core texts in the politics of financial regulation, Singer focuses on the domestic politics of capital regulation and regulatory agencies as the main actors rather than legislatures (Singer 2004). He asserts that regulators seek to avoid legislative intervention at home, and thus push for international regulatory harmonisation as a way of levelling the playing field in times of increased foreign competition and as a means of providing stability when confidence in financial institutions is declining (Singer 2007). His research attempts to explain the "varying preferences of regulators toward international regulatory harmonisation" and whilst his analytical framework combines aspects of Oatley and Nabors' and Kapstein's work, he believes it "offers a more compelling and analytically useful explanation of regulator preferences" (Singer 2004, p.534). Singer's framework essentially consists of overlaying two chart functions: the first is the relationship between regulators' stringency and confidence in the financial system, the second the function of financial stability and competitiveness of the domestic financial institutions. The point at which legislators threaten to intervene when either competitiveness or confidence falls below a certain level determines the actual win-set between regulators stringency, confidence and competitiveness that regulators have. When exogenous shocks cause a fall in either competitiveness and/or confidence in domestic financial markets, regulatory win-sets shrink or disappear, in which case regulators seek international regulatory harmonisation by way of re-establishing the status quo ante. The Basel accords, Singer argues, are exemplary of this.

Singer is one of the first IPE scholars to consider seriously why a comparable capital accord for investment banking under the auspices of IOSCO failed. He reconstructs the events leading up the SEC's outright refusal to establish an international agreement in October 1992. According to Singer, the UK's Securities and Investment Board (SIB) was eager to establish an international regulatory standard as London's merchant banks faced unprecedented competition following Thatcher's deregulation movement (known as the 'big bang') in 1986 and unprecedented financial volatility during the 'Black Monday' weeks in 1987.[10] Singer argues that the "SIB's advocacy of harmonisation was driven by competitive pressures in derivatives markets from US firms, combined with a heightened sense of vulnerability of asset prices to shocks

[10] The 'Big Bang' refers to a set of reforms that ultimately liberalised the London Stock Exchange and the United Kingdom's financial sector. The UK Parliament passed the Financial Services Act of 1986 that liberalised financial markets, but simultaneously established the SIB in a move to re-regulate finance. The SIB was charged to oversee the industry and act as regulator. As a result of the liberalisation, US and continental European investment banks and universal banks acquired nearly all British merchant banks and brokers within the years to follow. Black Monday is the commonly accepted name for 19th October 1987 when stock markets around the world crashed and stocks lost around 20% of their value.

from abroad and the precariousness of British securities firms in the wake of the 1987 stock market crash" (Singer 2007, p.69). He maintains that the public offer of the British government's remaining stake in BP (31%) just days after Black Monday was "bungled" almost completely unsubscribed and therefore left underwriters with tremendous losses, most of which were British and only a "small number from the United States and continental Europe". Despite the fact that the Bank of England set a floor for which it would purchase BP shares in order to alleviate the flow-back and financial loss, "underwriters were nonetheless left with losses totalling some £700m" (ibid, p.78). Singer highlights that no British merchant banks failed, but the SIB was nevertheless very nervous about the possibility of this happening and was thus pushing for regulatory harmonisation thereafter.

2.4.2.1 A critique of Singer

At first sight, Singer's argument about the problematic BP offering and the vulnerability of the British merchant banking system seems plausible. He references his claims about the SIB and the BP offering to the book *The Confidence Game: How Unelected Central Bankers Are Governing the Changed World Economy* (Solomon 1995). When Singer's arguments are checked against this book and then the book's data is referenced back to historical archives, such as the one from the Financial Times, several discrepancies come to shore. It is correct that N.M. Rothschild was the lead manager of BP's public offering, and Rothschild did ask to halt the issue after a majority vote of all 17 underwriters had voted in favour. The underwriters tried to invoke the "adverse change" clause in the underwriting agreement with the UK Treasury. However, the clause gave the Treasury the final say as to whether or not to proceed with the offering. In the end, Prime Minster Thatcher and the Treasury under Chancellor of the Exchequer Lawson decided to go ahead despite the fact that underwriters could face significant paper losses of more than £1bn. Singer's and Solomon's account is correct until this point. What both do not represent accurately are two key facts about the BP underwriting:

Firstly, whilst UK merchant banks did take up the largest proportion of the offering, they had 400 sub-underwriters in place that essentially dispersed the risk amongst this group, leaving no one severely exposed financially.

Secondly, the US banks underwrote some 23% of the total (480m shares), but none of them had any sub-underwriting (as this was illegal under US law) leaving them fully exposed to losses.

In actual fact then, the BP offering became a litmus test for the American and not the British merchant banks. As the Financial Times notes "the UK underwriters – led by N.M. Rothschild, the merchant bank – are carrying a relatively small part of this risk because 40 per cent of the issue has been underwritten overseas and the UK portion has been sub-underwritten with more than 400 institutional investors" (Tomkins 1987). Not only did the British merchant not have to worry about significant paper losses, but the American underwriters also faced tremendous financial pain. A day later, the FT reporters Anatole Kaletksy and Richard Tomkins went further and highlighted the fact that

> it is unclear just where the pressure for a withdrawal of the issue is coming from. Although the UK underwriters face by far the largest exposure to the issue, they have passed down most of the risk to well over 400 sub-writers. The exposure of these sub-underwriters is therefore limited, and they seem to be accepting their fate with good grace (Kaletksy 1987).

Kaletsky and Tomkins point out that of all the different countries, "probably the biggest losers would be the US underwriters – Goldman Sachs, Morgan Stanley, Solomon Brothers and Shearson Lehman" since sub-underwriting is not allowed in the US "because the price of a stock offering is not normally fixed until the actual day of the issue" (ibid.). The facts surrounding the underwriting and sub-underwriting of the BP issue directly contradict Singer's argument that "investors in London were less confident in the stability of their securities firms" with regard to the public offering. To the contrary, the Association of British Insurers stated publicly that "it resented any suggestions that its members might be trying to shirk their responsibilities" (ibid.)

and this despite them constituting a considerable portion of the sub-underwriters. It is thus factually incorrect to link the BP offering to a loss in confidence. It was the American underwriters who faced significant financial upheaval with this public offering and not the British merchant banks. Whilst these inaccuracies do not disprove Singer's argument and framework as such, they do cast significant doubts about the validity of his research in the area of securities and investment banking. In particular, it raises eyebrows with regard to whom he identifies as the protagonists in pushing for harmonising investment banking capital standards, and why.

Overall, the literature on Basel I set the scene for thinking about financial regulation in an IPE context. It is the scholarship on Basel II, however, that has fine-tuned this analysis, yet also introduced arguments about regulatory capture without empirical basis.

2.5 BASEL II

The Basel Committee on Banking Supervision released the *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*, known as Basel II, in June 2004. After a lengthy consultation process and the circulation of three major draft proposals (1999, 2001 and 2003), the Committee was finally able to establish a revision to the Basel I framework that all BCBS members and the heads of central banks and banking supervisors of the G-10 countries agreed on. Basel II's core objective is to "further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks" (Basel Committee on Banking Supervision 2006, p.2). Basel II was seen as bringing capital requirements more in line with best practices in the risk management industry. The mechanics and details of Basel II have been analysed and discussed at length, and the thesis will thus only provide an overview of Basel II's details that are relevant for understanding the political economy of investment banking regulation.[11]

Essentially, Basel II's framework rests on three pillars:

- Pillar I – Minimum Capital Requirements. This pillar provides the actual toolkits for calculating minimum capital requirements and what counts as capital;

- Pillar II – Supervisory Review Process. It sets out the compliance with minimum standards and the core principles of the review process;

- Pillar III – Market Discipline. This pillar aims to ensure that banks operate transparently and disclose to the markets essential details of their capital adequacy and risk management so that investors, "the market", can judge for themselves.

[11] An enormous amount of literature has been published in law and finance. For an overview, the thesis refers to Hal Scott's book *Capital Adequacy beyond Basel* (Scott, H. S. (2005). Capital adequacy beyond Basel : banking, securities, and insurance. New York, Oxford University Press.)

Above all, Basel II's new framework intends to ensure that banks calculate the value for the probability of default (PD), the loss given default (LPD), the exposure at default (EAD) and the effective maturity (M) of assets more precisely. As such, Basel II establishes a new and more differentiated set of risk weights. Irrespective of the size and sophistication of financial institutions, banks have to adhere to and apply these risk weights. Basel II does **not** allow banks to run their own risk models and create their own risk weights. This aspect is widely misunderstood. Basel II permits banks, subject to regulatory approval, to calculate their own values of PD, LPD and EAD and then use these when allocating appropriate risk weights as determined by the standard Basel II regulatory model.

Because not every bank has the capacity to calculate and analyse the PD, LPD and EAD values, Basel II offers banks three different risk weighting methodologies:

- The Standardised Approach – defines the risk weights for all asset classes. Banks identify these via ratings from external credit rating agencies or via the Basel II definitions in case external credit ratings are not available.

- The Foundation Approach, also known as the Internal Ratings Based (IRB) Approach – allows

  > banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure (Basel Committee on Banking Supervision 2006, p.52).

- The Advanced Internal Ratings Based Approach – based on the Foundation Approach, the Advanced IRB permits banks to use more internal estimates than is the case under the Foundation Approach.

It is fair to say that the IPE literature on Basel II is one of two cornerstones for the IPE of finance. Kapstein's assessment of the new capital accord is that it represents not merely a shared concern with financial stability and an ongoing balancing act of finding a more level and more stable playing field, but also a relief for the US to be the structural backdrop for stability in the global financial system (Kapstein 2006). He was one of the few economists who argued prior to the financial crisis of 2007 that Basel II and the shift towards securitisation and an originate to distribute model "has certainly freed bank capital and thus allowed greater lending activity to take place, [but] has not necessarily reduced systemic risk" (ibid, p.12).

Equally critical, Tarullo argues that Basel II is a 'milestone' since it significantly changed minimum capital requirements and was "unprecedented as an exercise in international regulatory coordination and harmonization" (Tarullo 2008, p.1), but "Basel II's detailed rules for capital regulation are not an appropriate basis for an international arrangement among banking supervisors" (Tarullo 2008). Tarullo dismisses Basel II on three principal grounds: firstly, IRB is a questionable and not yet tested method to calculate regulatory capital; secondly, he questions whether the gains received from cooperation actually outweigh the compliance costs; and lastly, with regard to the first two criticisms, Tarullo believes that given the uncertainty in applying Basel II in practice as well as its net benefits, a simpler and 'more eclectic' international arrangement would be better than Basel II. Focusing specifically on the implementation of Basel II in the United States, Herring highlights that the Fed initially wanted to move away from a leverage ratio and only require the Basel IRB approach for America's core banks, only to completely change course after the Quantitative Impact Study (QIS) 4 resulted in enormous differences in risk weights (ranging from 74% to less than 1%) for the same residential mortgage portfolio (Herring 2007). Interestingly, Herring refers to the efforts made by four large US banks – Citigroup, JPMorgan, Wachovia and Washington Mutual – which argued that they should not have to adhere to leverage ratio *and* Basel II since the largest US investment banks – those subject to the SEC Consolidated Supervised Entity Programme – could switch to an alternative net capital rule that incorporated many elements of Basel II. Herring's account is interesting in that he focuses on the implementation phase of Basel II, the industry's feedback and the QIS results and sets them in context with US investment banking, which none of the other authors did. He is also one of the few scholars to appreciate that Basel II does not allow banks to run their own risk models.

2.5.1 Regulatory Capture

Referring to Stigler's and Peltzman's theory of regulatory capture, several IPE authors assert that Basel II is a prime example of regulatory capture, yet give little more than anecdotal evidence to support these claims. Steil and Litan contend that the Basel accords are seriously flawed and de facto irrelevant, and only adhered to "if for no other reason than not to offend their regulators" (Steil and Litan 2006, p.25). They assert that the US follows their own regime of financial regulation, which is seen as more stringent than Basel. Moreover, Steil and Litan emphasise that the Basel accords were not drafted in consultation with banks, but rather that banks shaped regulatory policies (ibid., p.27). The authors make these considerable claims without any empirical backup.

A noteworthy exception in the Basel II IPE and regulatory capture literature is the research from Kevin Young. Young's work provides an empirical analysis of the Basel Committee on Banking Supervision's journey towards Basel II and the involvement of private sector interests. Building upon a comprehensive body of empirics as well as a wide range of interviews, Young demonstrates that private sector lobbyists had access to [what?] within the regulatory decision-making process, but that this did not always translate into influence and, surprisingly, sometimes led to even more stringent regulation (Young 2012).

2.5.1.1 Underhill and Zhang's analysis of Investment Banking

Underhill and Zhang argue that "the long-institutionalised relationship between regulators and the regulated in financial supervision […] approximates conditions of capture" (Underhill and Zhang 2008, p.546). They assert that "national capacities to provide such collective goods as market regulation or crisis management have been dramatically weakened" and that the "prevalence of private interests in rule-making processes undermines the establishment of an accountable and legitimate financial order" (ibid, p.536). Leaving aside the vast amount of literature that shows that delegating regulatory functions to independent regulatory agencies does not necessarily undermine legitimacy[12], the authors argue that financial globalisation is largely driven by private interests who have captured their regulators and can thus exert power without any accountability.

Underhill and Zhang build up a chain of causalities either without providing empirical backup or by skewing reality. For example, they claim that "financial firms and their associations have close and relatively exclusive relationships with regulatory agencies" and that "these symbiotic relations, prevalent across the leading economies of the G7, provide private interests with not only the opportunity to influence the nature of financial governance, but also the potential to capture regulatory processes" (Underhill and Zhang 2008, p.541). The first statement is not only uncontroversial, but also trivial, as it simply states the obvious fact that financial institutions have close relationships with regulatory agencies. It would be surprising, dangerous and nonsensical if regulators were not in a constant and close dialogue with the entities they regulate. In fact, central banks, such as the Federal Reserve Bank of New York, are a regulator and a market counterparty. This dialogue ensures an ongoing flow of information and market signals that allow financial institutions to flag up any potential dangers, and it gives supervisors an ongoing inside view of financial markets which they would otherwise not have.

It is the author's second claim, their deduction that because of this 'symbiotic relationship' between financial institutions and regulators that they have the potential to capture regulators. Clearly, a 'symbiotic relationship' is a necessary, but not sufficient condition to logically deduct that financial institutions capture their regulators. Furthermore, the authors provide no empirical backup for their claim of capture. They mix anecdotal hearsay with claims that are either not scientifically referenced at all or refer to works of their own. Underhill and Zhang use two case studies to underpin their theoretical claims: the governance of global banking and the governance of securities markets. As regards the first case, the authors continue making claims about regulatory capture without providing any information as to

[12] For an overview of the literature, see Thatcher, M. and A. S. Sweet (2002). "Theory and Practice of Delegation to Non-Majoritarian Institutions." West European Politics **25**(1): 1-22.

whether private interests were at all successful, and if so, how they were able to exert their power on regulators and the BCBS. As before, the authors draw direct deductions between documents published by lobby groups, such as the International Institute of Finance (IIF)[13], outlining the preferences of financial institutions and the consultative documents released by the BCBS claiming that in case there were overlaps “the pressure had worked” (ibid, p.544). Preferences expressed by a lobby group do not constitute a necessary condition to support the claim that the pressure had worked. Moreover, the authors fail to give any insights, let alone proof, as to how a lobby group, such as the IIF, can and does exert influence.

Underhill and Zhang’s second case study ‘IOSCO and transnational securities regulation’ displays the same shortcomings. They argue

> IOSCO member regulators, whose relationship to government may be characterised as ‘arm’s length’, have been more accountable to self-regulatory organisations (SROs) and private market participants than to traditional government oversight mechanisms, yielding a poorly defined sense of broader public interest and community in international regulatory developments (ibid, p.548).

This argument is factually wrong: the US Securities and Exchange Commission (SEC) is directly accountable to US Congress not only on ad-hoc basis through hearings and testimonies in front of House and Senate committees, but also on an annual basis via the Commission's annual budget request for the year ahead and the statements of accounts of the year gone by (called “Full Year Congressional Justification and Performance Plans”). In addition, the SEC is also accountable to the National Association of Securities Dealers (NASD). Underhill and Zhang fail to provide counter-evidence to these facts.

The authors go on to argue that “saturated US markets led investment bankers and institutional investors to seek overseas expansion to markets where they might also have a competitive edge, including Europe and the fast-growing East Asian economies. Regulatory convergence to establish international (largely American)

[13] The International Institute of Finance sees itself as the ‘world’s only global association of financial institutions’ and is based in Washington. Its membership encompasses financial institutions from around the world and different financial sectors, such as investment banking and commercial banking.

standards within the IOSCO policy community would accomplish this goal" (ibid, p.550). The argument is spurious at best, leaving aside the counter-movement of European bankers and investors acquiring American investment banks[14] and financial market platforms, and also references sources that do not make this claim: neither Simmons (Simmons 2001) nor Zaring (Zaring 1998) discuss it in their respective papers. The Underhill and Zhang piece is a good illustration for IPE scholarship on investment banking that relies upon simplistic logic and limited empirics to make claims that cannot be substantiated.

2.5.1.2 The 'Wall Street – Treasury Complex' and the SEC's net capital rule

Wall Street Treasury Complex & Financial Crises

The IPE literature on financial crises is more established and varied than on banking, security markets and finance. Within this body of scholarly work, several accounts link an analysis of financial crises with an examination of financial regulation and the role of 'Wall Street'. One of the first and most widely referenced texts to discuss 'Wall Street' and its influence on the US executive and financial regulation is Jagdish Bhagwati's article *The Capital Myth* which Foreign Affairs published in the aftermath of the Asian Financial Crisis in 1998 (Bhagwati 1998). This article is built around an argument Bhagwati made in an interview with the Times of India. There, he stated that "Wall Street has become a very powerful influence in terms of seeking markets everywhere […] just like in the old days there was this 'military-industrial complex', nowadays there is a 'Wall-Street-Treasury complex' because Secretaries of State like Rubin come from Wall Street. […] So today Wall Street views are very dominant in terms of the kind of world you want to see" (Times of India 1997).

In Foreign Affairs, he asserts that the "Wall-Street -Treasury Complex" created the myth that capital account liberalisation would bring enormous benefits without causing any major crises, hence the article's name "The Capital Myth"

[14] Examples of European banks acquiring American investment banks are:
Credit Suisse acquiring a majority stake in First Boston (1990), today's UBS (Swiss Bank Corporation) acquiring Dillon Read (1997), Deutsche Bank acquiring Bankers Trust (1998), today's Commerzbank (Dresdner Bank) acquiring Wasserstein Perella (2000), UBS acquiring PaineWebber (2000), Credit Suisse acquiring Donaldson, Lufkin & Jenrette (2000)

(Bhagwati 1998). He argues that "Wall Street has exceptional clout with Washington for the simple reason that there is […] a definite net-working of like-minded luminaries among the powerful institutions - Wall Street, the Treasury Department, the State Department, the IMF and the World Bank most prominent among them" (ibid, p.11). Whilst he does not give any empirical support to prove that there is a 'definite net-working of like- minded luminaries', he argues that because of the rotating door between Wall Street and these institutions,

> this powerful network, which may aptly, if loosely, be called the Wall-Street-Treasury complex, is unable to look much beyond the interest of Wall Street, which it equates with the good of the world (ibid, p.12).

Bhagwati's – somewhat polemical – justification for his concept of the Wall-Street-Treasury complex rests on the idea that because top executives from Wall Street had a second career in Washington, they *must therefore* capture Capitol Hill, the IMF and the World Bank, and *must* be able to mould these institutions according to Wall Street's preferences. This is a very spurious argument and stands without empirical grounds. Despite this lack of proof and its anecdotal nature, Bhagwati's article in Foreign Affairs has become one of *the* reference points for academics working in the field of IPE.

In this context, Wade and Veneroso assert that this 'Wall-Street-Treasury complex' helped "to push the process of amending the IMF's articles of agreement to require member government to remove capital controls and adopt full capital account convertibility" (Wade and Veneroso 1998, p.19) and influenced the WTO in 'hammering out' an agreement on liberalising financial services (Wade and Veneroso 1998). Wade and Veneroso's focus rests on the concept of capital mobility, the rise of Asia and the IMF policies. Wall Street, however, is seen as an important, if not *the* variable in bringing about capital account opening and pushing through its agenda in the international financial institutions. The problem with the argument rests on the role of 'Wall Street'. As discussed above, Bhagwati himself did not present any empirical evidence other than highlighting the fact that senior public officials joined Wall Street banks during their careers and vice versa. With regard to Wade and Veneroso, no empirical evidence is presented other than Bhagwati's interview with the Times of India. More importantly, the authors appear to use 'Wall Street' as a placeholder for finance at large. For example, they cite an article by the Financial Times reporter De Jonquieres's which states that "executives of groups including Barclays, Germany's Dresdner Bank, Societe Generale of France and Chubb Insurance […] agreed discreetly to impress on finance ministers around the world the benefits of a WTO deal" (ibid, p.19). At the time, Société Générale and Chubb Insurance had little to do with the likes of 'Wall Street', such as Goldman, Sachs or Lehman Brothers.

To be clear, the purpose of reviewing scholarly pieces like this one is not to critique the authors' arguments as such. Rather, the thesis critically examines these pieces to build up its case that academics make assertions about investment banking and its actors without understanding what this industry actually does, and whether it actually yields the influence over politics so many believe it enjoys. After all, Wade and Veneroso examine the impact of financial liberalisation on Asia, the Asian Financial Crisis and the IMF's structural conditionalities. It is the latter aspect where the authors make assertions about 'Wall Street' or 'investment banking' and their alleged power in politics without providing empirical backup, and/or identify financial institutions as 'Wall Street' actors, even though not all of the actors they identified are investment banks.

Besides the concept of the 'Wall-Street-Treasury Complex', many scholars claim that Wall Street 'captures' its regulators (Underhill and Zhang 2008) and/or that 'Wall Street' successfully lobbied for the repeal of the Glass Steagall Act (Helleiner 2011). The argument of regulatory capture is often insufficiently supported, or presented as an evident truth that needs no further explanation. Bello's article about over-accumulation and financial crises caused by capitalism is a good example (Bello 2006). He asserts that the Clinton administration was closely tied to Wall Street via Treasury Secretary Robert Rubin (ibid, p.1361). Like Bhagwati, Bello simply assumes that by virtue of having a top public official who had previously worked in investment banking, Wall Street has direct links with the US government. This line of reasoning is simplistic and without further support.

Andrew Baker goes one step further, emphasising "financial regulatory capture was most pronounced in the Anglo-American heartland of the global financial system, in the heavily 'financialised' societies of the United States and the United

Kingdom […] indeed, financial regulatory capture was a key defining feature of the political economy of these countries, often alluded to in the evocative phrase 'Wall-Street-Treasury complex'" (Baker 2010, p.648). Indeed, we learn from him that

> at some point in the early 2000s regulatory capture become so extreme that it breached a crucial threshold and became dangerously pathological, facilitating the excessive risk-taking that led to the bailouts of 2008 (ibid, p.649).

What scale Baker uses to assess this threshold remains unclear, but he goes on to argue that "the general trajectory of reform […] was entirely congruent with the *banking* industry's wishes" to which he lists the repeal of Glass Steagall as well as the SEC's CSE programme (ibid, p.652).

The problem with this argument is that Baker confuses investment banks with commercial banks. Glass Steagall was revoked in large parts long before the passing of the Gramm Leach Bliley Act. In fact, as the dissertation will show, this was made possible because of a Fed decision, which the US courts confirmed in the face of fierce contestation from the investment banks. Moreover, the SEC's decision to allow the most highly capitalised US investment banks to move from the SEC's traditional net capital rule to a new capital standard for investment banks (and not commercial banks) that was more in line with Basel requirements was seen as best practice at the time, rather than regulatory capture. This move was not driven by the US investment banks, but by the European process of establishing integrated single markets in finance. We will discuss the net capital rule issue in more detail below.

Baker's concept of 'intellectual and cognitive capture' is an interesting one, though he gives little evidence for it other than referring to Alan Greenspan's aura as a free-marketer. His notion about a 'Wall Street - Washington corridor' and an especially strong link between Goldman Sachs and the US Treasury and the Fed suggest that something untoward could be going on, since he notes just a sentence beforehand that some of the literature on regulatory capture has highlighted how regulators are encouraged to become compliant with industry wishes through implicit promises of lucrative future careers in the regulated industry" (ibid, p.652). Again, simply stating "Robert Rubin, Henry Paulson and William C. Dudley are among the better known individuals marking that journey, while Gerald Corrigan left the New York Federal Reserve and became CEO of Goldman's" (ibid, p.652) highlights that there is a revolving door, but it is not a sufficient condition to infer that this causes regulatory capture, let alone that these people sought to benefit from their public service.

Helleiner and Porter also regard the door between Wall Street and regulators as approximating situations of capture. They argue

> this problem of capture [referring to the capture of the Basel Committee] at the transnational level is amplified by the propensity for a similar problem between regulators and the industry at the domestic level […] there are many who perceive that the circular door between Goldman Sachs and other leading firms and government has led to ineffective regulation and privileged treatment for financial firms (Helleiner and Porter 2009, p.22).

Helleiner and Porter's article focuses on the alleged lack of transparency of transnational networks for financial regulation and the susceptibility of capture. This is despite the authors' emphasis that "powerful states can also manipulate informal settings where there are no clear rules or procedures to protect the weak" (ibid, p.18) which makes their argument seem somewhat inconsistent. If powerful states can 'manipulate' informal settings, such as Basel, then surely these governments will be powerful enough to fend off regulatory capture as well as being well informed.

In another piece, Helleiner displays a lack of knowledge about investment banking when he asserts that

> although common international capital standards were developed for banks, those standards did not apply to the institutions that were becoming more and more systemically important because of securitisation trends, such as investment banks, insurance companies and hedge funds (Helleiner 2011, p.72).

The opposite is true for investment banks where Helleiner's arguments are wrong. The SEC's Consolidated Supervised Entities (CSE) Programme is in large part aligned with the Basel accords, and it was *because* it applied many elements of the

Basel Accord capital adequacy, such as bank internal Value at Risk models for purposes, that investment banks' net capital decreased. Helleiner goes on to asset that "in 1999, the U.S. Congress largely repealed the separation of investment and commercial banking that had been established after the Great Depression" (ibid, p.73).

As the dissertation shows in its case studies, this separation was eroded in all but name decades before the passing of the Gramm Leach Bliley Act in 1999. Helleiner also analyses regulatory trends and pays special attention to capture. Here, he cites the Underill & Zhang piece discussed earlier. It is disconcerting, however, that Helleiner also includes a rather pop-science book as IPE scholarship, called *13 Bankers – the Wall Street Takeover and the Next Financial Meltdown* and written by Johnson and Kwak (Johnson and Kwak 2010).

Johnson and Kwak, too, discuss the 'Wall Street – Washington Corridor', and note that the "constant flow of people from Wall Street to Washington and back ensured that important decisions were made by officials who had absorbed the financial sector's view of the world and its perspective on government policy, and who often saw their future careers on Wall Street, not in Washington" (ibid, p.93), insinuating that the "prospect of landing prestigious or high-paying jobs in the financial sector may also have influenced the decision of regulators and administration officials, who may have had an incentive not to make enemies among their potential future employers" (ibid, p.96). Neither of these two claims is empirically backed up. Later on in the same chapter, the authors cite Bhagwati's Wall-Street-Treasury Complex, arguing that "the power of Wall Street reached deep into Washington" (ibid, p.118). Whilst the authors are amongst the very few to pick up the Federal Reserve's decision on allowing commercial banks to provisionally re-enter some investment banking activities via a so-called section 20 subsidiary in 1987, they, bizarrely fail to understand its importance as they claim later on in their book

> the passage of Gramm-Leach-Bliley freed not only Citigroup but also Bank of America, J.P. Morgan, Chase, First Union, Wells Fargo, and the other commercial megabanks created by the ongoing merger wave to plunge headlong into the business of buying, securitising, selling and trading mortgages and mortgage backed securities (ibid, p 134).

With the Fed's decision to lift the limit for revenues from investment banking activities of Bank Holding Companies to 25% (Federal Reserve 1997), Bank Holding Companies, such as Wells Fargo were already able, pre Gramm-Leach-Bliley, to acquire some of Wall Street's most iconic investment banks such as Merrill Lynch. Both authors fail to give a detailed analysis of what the Fed's section 20 decision meant for the development of the US investment banking industry, and fail to understand that Gramm-Leach-Bliley had no significant bearing on commercial banks' ability to undertake investment banking.

2.5.1.3 The SEC net capital rule

A lot has been written in academic as well as journalistic circles about the SEC's decision to allegedly change broker dealers' net capital requirement back in 2004. It is this decision that many scholars and journalists take to be the root cause of the explosion of leverage in investment banks. Helleiner notes that "in 2004, the U.S. Securities and Exchange Commission lifted a 12:1 leverage ratio for investment banks, a move that enabled them to engage in greater risk taking" (Helleiner 2011, p.73). Similarly, Johnson and Kwak state that

> on April, 28, 2004, the Securities and Exchange Commission agreed to a *request* [emphasis added] by the five large investment banks – Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns – to use their own internal models, based on historical data to calculate "net capital" in their broker-dealer operations (Johnson and Kwak 2010, p.140).

Blundell-Wignall, Deputy Director of the OECD Directorate for Financial and Enterprise Affairs, argued in a joint publication with Paul Atkinson and Se Hoon Lee, that "US banks and or investment banks supported and lobbied the US authorities first to remove Glass Steagall in 1999, move to new SEC rules in 2004: and to adopt Basel II as soon as possible" (Blundell-Wignall, Atkinson et al. 2008). The list of famous academics goes on; Reinhart and Rogoff assert in their otherwise well-researched book, 'This time is different'

> what could in retrospect be recognised as huge regulatory mistakes, including the deregulation of the subprime mortgage market and the 2004 decision of the Securities and Exchange Commission to allow investment banks to triple their leverage ratios (that is, the ratio measuring the amount of risk to capital), appeared benign at the time (Reinhart and Rogoff 2009).

In journalistic circles, it is astonishing that the famous New York Times has been a forum for publicising similar arguments about the SEC's net capital rule decision in 2004. The paper's senior correspondent Steve Labaton wrote

> the decision, changing what was known as the net capital rule, was completed and published in The Federal Register a few months later. With that, the five big independent investment firms were unleashed. In loosening the capital rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms' own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves. Over the following months and years, each of the firms would take advantage of the looser rules. At Bear Stearns, the leverage ratio — a measurement of how much the firm was borrowing compared to its total assets — rose sharply, to 33 to 1. In other words, for every dollar in equity, it had $33 of debt. The ratios at the other firms also rose significantly (Labaton 2008).

A few months later in January 2009, Princeton Professor of Economics Alan Binder published his 'economic view' titled 'Six Errors on the Path to the Financial Crisis" in the Times (Blinder 2009). He asserted that

> the second error came in 2004, when the S.E.C. let securities firms raise their leverage sharply. Before then, leverage of 12 to 1 was typical; afterward, it shot up to more like 33 to 1. What were the S.E.C. and the heads of the firms thinking? Remember, under 33-to-1 leverage, a mere 3 percent decline in asset values wipes out a

> company. Had leverage stayed at 12 to 1, these firms wouldn't have grown as big or been as fragile (Blinder 2009).

The SEC's Consolidated Supervised Entity Programme is one of the most misunderstood and poorly researched topics in academia. The SEC's establishment of the CSE programme in 2004 was in reaction to the European Union's Financial Conglomerates Directive (European Financial Conglomerates Committee 2004) which required all third country financial conglomerates active in the EU to be supervised on a consolidated basis or else be required to establish a separately capitalised holding company in the European Union. As the SEC's investment banking supervision was not on a consolidated basis, the Commission had to establish the CSE programme to offer all US investment bank consolidated supervision. The SEC changed the net capital rule to bring it in line with Basel requirements – something the US investment banks would have been subject to if they had moved their holding to the EU. The investment banks certainly did not seek to be supervised on a consolidated basis – neither in the EU nor in the US.

As the dissertation highlights in its case study on the net capital rule, not only did leverage not go up significantly for most US investment banks, it had also been much higher in the past under the so-called old net capital rule. Moreover, British merchant banks have been subject to Basel rules ever since and the SEC believed – as did the entire policy community – that the CSE Programme followed so- called 'state of the art' risk management techniques (such as Value at Risk models) and required those who participated to essentially have $5bn in liquid equity at all times.

The SEC actually invited them to join their CSE programme – so as to establish equivalence in regulation as required by EU regulation – part of which meant that they would apply Basel II capital standards rather than the US net capital rule. The invitation to join the CSE was only partly a voluntary one, as the European Union's Capital Directive required all investment banks with operations within the EU, which at that point included London, to be subject to consolidated supervision. All US investment banks thus had a choice between being regulated by the UK's Financial Services Authority or else ensuring that their home country regulator in the

United States introduced a regulatory regime that the EU could pass as 'equivalent' to the EU's. In short, the CSE was not a Wall Street lobbying effort; it was a regulatory necessity courtesy of the EU. It is striking how many senior economists, journalists and academics did not properly understand the SEC CSE programme and produced factually incorrect publications.

2.6 THE NON-IPE LITERATURE ON INVESTMENT BANKING

A small range of works exclusively focusing on investment banks exists so far only in the non-political science field. Probably one of the most cited accounts is *Investment Banking: Institutions, Politics, and Law* by Morrison & Wilhelm (Morrison and Wilhelm 2007) and Carosso's *Investment Banking in America* (Carosso, Sears et al. 1970). Contrary to the title, Morrison and Wilhelm neither analyse investment banking from a political science perspective nor provide insights into the politics of investment banking vis-à-vis governments. This is not surprising, since Morrison and Wilhelm have finance and IT backgrounds: Morrison is currently professor of finance at Oxford's Said Business School, while Wilhelm is Professor of Finance at the University of Virginia. Carosso was an economic historian and his scholarship is in history, not political science.

The eminent economic historian Cassis provides an impressive overview of the history of banking and regulation, yet falls foul of the so-called 'repeal' of Glass Steagall too. He argues that "in 1999 the Glass-Steagall Act of 1933 was abolished with the arrival of Financial Modernisation Act […] it had been de facto emptied of its substance after the American cartel authorities had in 1998 ratified the marge, under the name of Citigroup, of Citicorp and Travelers" (Cassis 2006). Knowing the history of Glass-Steagall, this argument is incorrect.

Other scholars examine investment banks through the lenses of a historian, such as Morton (Keller 1963), Michie (Michie 1986), Redlich (Redlich 1968), Scott (Scott 2005), Shultz & Caine (Shultz and Caine 1937), Sylla (Sylla, Tilly et al. 1999) and White (White 1986) or through the lenses of finance scholars, such as the famous book *Corporate Finance* (Brealey, Marcus et al. 1995) and McKinsey's core book *Valuation* (Koller, Goedhart et al. 2010).

2.7 RELEVANT LITERATURE ON THE IPE OF INVESTMENT BANKING

Having conducted various and extensive literature searches on the topic of financial regulation and investment banking over many years, there are currently only two works which stand out because they are empirically sound. Firstly, Abdelal's book *Capital Rules* analyses the causes as well as the consequences of liberal rules for global finance (Abdelal 2007). Rather than simply relying on secondary sources, Abdelal conducted extensive archival research and elite interviews. His findings contradict academia's mainstream ideas about financial globalisation, especially the concept of the Wall-Street Treasury complex. He argues that

> there is, remarkably, almost no evidence to support this conventional wisdom […] instead Treasury policymakers were at best indifferent to the capital liberalisation amendment, and some senior officials even opposed its progress [whilst] Wall Street was unambiguously against the amendment (ibid).

Rather, after Mitterrand's failed attempt to revive socialism in 1982, the French left changed track and supported the process of 'managed globalisation' that ultimately made the European Union's and later the OECD's rules for capital account convertibility the most liberal in the world. Abdelal's detailed process tracing exercise combined with his collation of primary data allows him to reconstruct the decision-making processes behind financial liberalisation. His scholarship contrasts with Helleiner's and Underhill's, who have a tendency to rely upon a body of work that is (and becomes through doing so) self-referencing.

The second noteworthy piece is the recent journal article *Paving the Road to "Too big to Fail": Business Interests and the Politics of Financial Deregulation in the United States"* by Suarez and Kolodny. It is one of the first, if not the first, work in IPE to sketch out some of the complex history of the Gramm-Leach Bliley Act (Suarez and Kolodny 2011). The authors analyse the interests and alignments of the financial sector's various lobby groups, in particular the American banking, investment banking and insurance industry. Whilst not relying upon primary data, they assert that Glass Steagall was ultimately only repealed when all three financial lobby groups joined forces and pushed together for legislative change. However, the piece is not without faults. The authors cannot explain – which is the actual crux of the matter – *why* the Fed decided to allow some commercial banks to re-enter investment banking activities in 1987. This somewhat undermines their argument. They state "in a puzzling decision, the Fed – which was still under the chairmanship of Paul Volcker – granted the banks' [commercial banks] request as long as the securities activities did not exceed 5% of the subsidiary's total revenue" (ibid). At the same time, the authors do not pay attention to the role of the courts. Irrespective of any legislative stalemate (as was the case) or change, litigation brought up regulatory change.

2.8 CENTRAL WEAKNESSES OF THE LITERATURE

The literature on the politics of finance is a relatively young discipline within IPE. Most accounts about the IPE of financial regulation were written in the last twenty years or so. However, the central weaknesses of the IPE of finance literature can be separated into three categories: focus, accuracy and empirics.

The literature review has demonstrated that the overwhelming majority of pieces focus on commercial banking and the Basel Accords. One of the central weaknesses is thus a simple lack of analysis on the IPE of investment banking. A gap exists between what has been written about 'Wall Street' / investment banking and "reality". One of the literature's key weaknesses is thus content-related. Wall Street often features as one of the factors in IPE texts, such as the accounts on financial crises or the Basel Accords, but a comprehensive examination focusing on investment banking is missing so far. This matters because investment banks can be or become systemically relevant for countries' economies as the bankruptcy of Lehman Brothers in September 2008 has shown. Only with a thorough understanding of the investment banking industry and its actors can policymakers pass and review regulation that is advantageous for societies, allows for innovation and entrepreneurship whilst appropriately managing and containing down-side risks. Academics can only produce relevant and empirically sound research if they fully comprehend the subject they are studying.

A second shortcoming can be summarised with the term 'accuracy', which refers to common misunderstandings amongst many IPE scholars about the nature, regulation and thus political economy of investment banking. IPE texts that do cover aspects of investment banking often contain significant inaccuracies. As discussed earlier, these errors range from regulatory matters, in the case of Helleiner (Helleiner 2011), to confusing investment banks with commercial banks or getting some facts simply wrong as shown with the BP offering in Singer's book (Singer 2007).

Finally, the thesis makes a distinction between inaccurate texts and those accounts whose claims either cannot be verified with data, or lack data. This last category applies to the majority of pieces on the Wall-Street–Treasury complex and regulatory capture at large. It is scientifically questionable simply to deduct that Wall Street captures Washington by virtue of people's careers. Incorrect assumptions about the nature of the business and thus its power in politics often feed into research like this. Bhagwati (Bhagwati 1998), Baker (Baker 2010), Helleiner and Porter (Helleiner and Porter 2009) and Underhill (Underhill and Zhang 2008) fall into this category.

Currently, most books and journal articles about investment banking have been published outside the social sciences, let alone the IPE of finance. These publications review investment banks from a finance and economics or legal studies angle. This thesis not only provides one of the first accounts of the political economy of investment banking, but also highlights the importance of the role of ideas role and the role of the courts as part of the IPE of investment banking discourse. The latter aspects, the role of the courts, is a completely new subject area in the IPE of finance.

Chapter 3

RESEARCH DESIGN AND THEORY CHAPTER: OF VARIABLES AND HYPOTHESES

3.1 THE RESEARCH PUZZLE

As the literature review has shown, there are central weaknesses and gaps in the current IPE scholarship on finance. It has been said that Wall Street is extremely powerful in politics largely by virtue of lobbying and the revolving door, yet the empirical support for these claims has remained meagre. Indeed, examining Wall Street's campaign contributions paints a different picture. The securities and investment industry is ranked outside the top ten industry (ranked 12th) for total campaign contributions between 1998 and 2012 (Opensecrets.org 2012). The industry also donated a roughly equal amount to Democrats and Republicans alike over a time period spanning more than two decades, which makes claims about partisanship difficult to maintain (Opensecrets.org 2012). Even though much emphasis is given to the financial power of Wall Street and campaign contributions, the facts portray a reality which makes it very hard to use campaign contributions as a major factor in determining legislative outcomes. The thesis has thus not examined them further and seeks to show that other factors are at play that are powerful determinants in how financial regulation and its change are brought about.

The dissertation's research objective is to uncover the political economy of investment banking regulation in the US, starting with the end of Bretton Woods in the 1970s and culminating at the peak before the financial crisis of 2007/8. In doing so, the dissertation identified a range of case studies that are interconnected and tell the story of how regulators and legislators took decisions that shaped US investment banks' developments. The cases have been selected by virtue of their impact on Wall Street and on a measurable 'reduction in regulation': sometimes in favour of investment banks, sometimes against them and sometimes done with unintentional consequences. Because of the significant empirical gaps in the current literature, it is not clear how - if at all - the investment banking industry uses mechanisms such as the 'revolving door' to exert influence on regulators, other executive branches or the legislative. This comes against the backdrop of the logical tautology of the 'lobbying thesis', that is, if investment banks were such powerful institutions moulding Washington and Westminster to their liking, why would they then need to lobby in the first place if the status quo allegedly reflects their preferences?

Likewise, we know little about what role institutions play in investment banking regulation. Many IPE publications have focussed on banking regulators - overwhelmingly researching Basel I / II / II.5 - not investment banking regulators such as the US Securities and Exchange Commission (SEC). As the literature review highlighted, journalists and researchers alike mix up commercial with investment banking, at times using both indiscriminately. This carries serious consequences for their analysis and arguments: commercial banks and investment banks are completely different legal entities that follow distinct business models. Commercial banks are deposit-taking financial institutions, whilst investment banks are inter-broker dealers, i.e. non-deposit-taking. As a result, commercial banks and investment banks are subject to different regulatory regimes and ultimately have different, at times opposing, business interests and lobbying incentives.

Institutions matter, but maybe not always according to conventional academic wisdom. It is said that financial regulators, being mandated by and accountable to legislatives, uphold the 'rules of the game'. However, as this thesis shows, in various instances regulators established *new* rules of the game that were or were not within their statutory authority. Typically, it is the mandate of the legislature to create *new* rules.

The case study on the SEC's Consolidated Supervision Entity Programme (CSE) will show that the SEC established the CSE as a voluntary regime as it lacked the statutory authority to create an obligatory other. It nevertheless succeeded in doing so with the five largest US investment banks signing up and no court cases threatening it.

By contrast, the US Commodity Futures Trading Commission (CFTC) issued a concept release (Commodity Futures Trading Commission 1998) on over-the-counter (OTC) derivatives markets seeking the public's and industry's view on the future of OTC derivatives market regulation. The CFTC was fully within its statutory remit to amend the then existing regulation and exemption from regulation for certain swap OTC derivatives, and certainly to issue a concept release. The release caused an enormous uproar amongst other US regulators, legislators and market participants alike, so much so that despite its statutory authority, the CFTC failed in even contemplating any revisions to OTC derivatives regulation and its Chair was essentially forced to resign.

In a third case, the US Federal Reserve used the Courts to 'test' and re-define the boundaries of its statutory authority so much so that it completely undermined the Glass Steagall Act's division between investment banking and commercial banking in practice, though not de jure (Federal Reserve Bank of New York 1933). The three Glass Steagall case studies analyse how a completely overlooked institution, namely the courts, changed the course of US financial regulation by way of its interpretative rulings. The role of a nation's courts is enormously important for interpreting, upholding, but also changing the financial regulatory regime. The case studies on the repeal of Glass Steagall tell a story of how the Federal Reserve pushed its statutory authority in interpreting and thus amending existing laws to the very limit so that it could cause significant regulatory change without any legislative input. The Federal Reserve's actions followed a landmark judgement from the US Supreme Court whose ruling provided a radically different reading of Congress's intent of the Glass Steagall Act.

Finally, we need to know more whether people's ideas or pre-conceptions about regulation are a factor in influencing regulatory outcomes. Without wanting to enter philosophical debates about 'what comes first – a person's idea or a person's interest?' ideas clearly matter in people's lives. Here, the dissertation follows – as illustrated in the literature review – in the footsteps of constructivism. The very fact, to refer to philosopher Raymond Geuss (Geuss 2001), that we are born into a world occupied, dominated and ordered by a vast amount of artificial constructs, probably the most powerful of which is the nation-state, reflects that ideas are omnipresent and actually steer mankind's history. The real question for the dissertation is then is not whether ideas matter, but how they matter?

Many academics, especially (political) economists, dismiss the role of ideas outright – largely on the basis that they are not measurable, which might be true in the most direct sense. However, the thesis is not about 'measuring' ideas, but about identifying which ideas and ideologies influenced regulatory policy elites, such as Federal Reserve Board Members and SEC Commissioners. The irony being that as a profession, economics appears to be inseparable from political ideology. As a social science, economics has its birth cradle in political science, however much some economists wished for it to be classified as mathematics. As much as political thought follows ideological lines, so does economics. So-called schools of thought build upon ideas as their guiding principles. Examples of these are the Chicago School (associated with the likes of Milton Friedman and Gary Becker), Keynesianism and ordo-liberalism (which emanated from and is still powerful in German academia and politics). Ideas have not only influenced economists, but clearly play a significant role in the day-to-day lives of humans. One of the most obvious examples is party politics. Many US voters have traditionally identified themselves with one of the two dominating political parties – Democrats and Republicans. In fact, citizens even vote for party manifestos that may actually leave them financially worse off. In the case of voting behaviour and patterns, one cannot assume that voters behave rationally (Frank 2005).

It is surprising that there appears to be a complete disconnect in large parts of economics and the IPE between accepting that ideas shape their academic schools of thought, yet when it comes to researching real-world phenomena, ideas - as an explanatory variable - often fall by the wayside since they are not 'measurable' in a conventional manner. Scholars that do include ideas as a variable, often attribute the white noise in their statistical calculation to ideas, only very few take them seriously, such as Mark Blyth (Blyth 2002).

Equally important is the fact that not a single research programme on the international political economy of investment banking exists. Whilst this thesis hopes to be a stepping-stone in theory building for future scholars in the IPE of investment banking, it likewise sits within the wider IPE of finance realm. Here, the dissertation aims to probe the plausibility of one of the core theoretical approaches in IPE, namely *interest, ideas and institutions*, which often are a mixture of all three. Applying appropriate explanatory variables from these three approaches will guide the dissertation in unlocking the puzzle as to why officials made conscious decision not to regulate key areas of finance, especially investment banking.

Given this background, we are left with several paradoxes: firstly, claims made about investment banking often actually refer to commercial banking, including, but not limited to, its regulatory institutions. This leads to the second paradox, namely that a large body of work exists in the political economy of commercial banking and its regulation, such as the literature on the Basel accords. However, we know very little about the political economy of the regulatory institutions behind investment banking, which is completely separate from the Basel accords. Investment banks do not have recourse to a lender of last resort; in fact, their regulators principally focus on liquidity so that in a crisis, investors receive all their money back whilst the investment bank is – in the literal meaning of the word – liquidated without causing market upheavals. Drexel Lambert Burnham was liquidated within months. Lehman Brothers caused shock waves, not because it was systemically relevant, but because entire market segments became illiquid, so much so that the failure of Lehman Brothers was simply the tip of the iceberg or the straw that broke the camel's back. Finally, the rare IPE publications that do examine investment banking correctly, i.e. as investment banks and not as commercial banks, are backed up with hearsay rather than hard data.

3.2 A HOTLY CONTESTED FIELD: RESEARCH DESIGN

Qualitative research is fundamentally different in its causal analysis from quantitative research. Both strands of scientific inquiry are equally important without one being superior over the other. It is relatively easy to legitimately and legally use quantitative methods either to make insignificant facts look important or play down financial/operational problems. Financial engineering, which is standard practice in the business world, should be a warning for all those economists who place near dogmatic faith in statistics. As much as statistics can be a powerful analytical tool, it has severe limitations and is open to easy manipulation.

The same can be said for qualitative research methods. Here, one can rarely make generalisations from focussed (some would call it narrow) case studies, and theory-building is challenging. Qualitative case study design is small N and its case selection is, by default, manipulated from the start. This statement will surely come to the great dismay of many qualitative researchers, yet it is simply not feasible to select case studies at random for researching, and then analyse one's research topic whilst hoping that the randomly chosen cases will somehow magically fit. In other words, the qualitative case study selection has to be biased, as the small N group out of infinite number of large Ns has to correspond to the researcher's question. Consequently, there are fundamental strengths and weaknesses inherent in both research designs, and the author could hardly imagine something less appealing than joining the discussions, often led with evangelical zeal, as to the flaws and weaknesses of specific research designs and methodologies. Academics should recognise that different research methods correspond to different research goals and learn from each other. This chapter is thus not a discussion about the merits and shortcomings of research designs. Instead, it examines and explains why certain research designs are the best fit for the dissertation's research aim, which is to uncover why the US authorities decided not to regulate investment banking.

3.2.1 The Logic Of Research Design And The Case Study Method

As Mahoney and Goertz highlight, qualitative analysts use a "causes-of-effects" approach, as opposed to quantitative researchers who follow the "effects-of-causes" logic (Mahoney and Goertz 2006). The former start with selecting a small number of cases, often on their outcomes, and then seek to uncover the necessary causes that led to the specific outcomes. By contrast, quantitative scholars calculate estimates of average effects on causes across a large N of cases. The dissertation's research design is qualitative and as such based on two methodologies: comparative case study research and within case analysis.

The dissertation follows George and Bennet's definition of a case as

> an instance of a class of events [whereby] the term 'class of events' refers […] to a phenomenon of scientific interest, such as

> revolutions, types of governmental regimes, kind of economic systems, or personality types that the investigator chooses to study with the aim of developing theory or generic knowledge regarding the causes of similarities or differences among instances (cases) of that class of events (George and Bennett 2005).

The thesis is interested in understanding the 'causes of effects' and unearthing the conception of causation in terms of necessity. It is impossible to find sufficient conditions in qualitative research (Dion 1998). For example, research claiming that cloudy skies are a sufficient condition to explain Vitamin D deficiency can easily be falsified by just finding one person from a sunny region that also suffers from Vitamin D shortage. Using the same logic, but now within qualitative research, imagine an academic claiming that capital account liberalisation is a sufficient condition for economic growth – a claim he/she proves by examining five different countries (i.e. the US, France, Germany, the UK and Sweden). One would only have to analyse China - which has enjoyed rapid economic development, yet has had strict capital controls in place - to prove this claim wrong. Likewise, in the case of IPE, I am looking at necessary conditions for an absence of financial regulation of investment banking.

Despite the absence of relevant research programmes on investment banking regulation, let alone quantitative data-sets, there is an abundance of empirical data on investment banking. The majority of this data consists of thousands of legal documents, regulatory filings, speeches and testimonies and articles from newspapers and magazines. The thesis examined the vast majority of this corpus of data and also conducted nearly 40 semi-structured elite interviews with the world's top regulators, bankers and lawyers. The elite interviews were an absolutely essential part of this research, and the author was fortunate to have gained access to *the* most senior private and public actors relevant to financial regulation in the UK, the US and officials from international organisations, such as the Bank for International Settlements and the International Organization of Securities Commissions (IOSCO). The interviews provided an opportunity for a deep-dive on the key regulatory changes, business decisions, legal changes and laws that they were involved with, questions their motives for the decision-making and understand the rationale behind those motives.

The interview data was crucial to filling any gaps in the publicly available data and, vitally, interpreting the causality of events. All interviews were all non-attributable, mostly digitally recorded (some in part, some in full, others were not recorded at all), but filed and its output presented so as to prevent anyone from ever identifying who is behind the statements made. The interviews partners were or still are in the highest ranks of government, central banks, financial regulatory bodies, investment and universal banks, law-firms, and lobby groups. The author would like to highlight that the data gathered this way contains highly sensitive information that could cause reputational, legal and financial damage to several institutions and individuals in question. The fact that all the interviews are non-attributable is thus a small price to pay in return for the interviewees' time and candid responses. The author would like to thank them again.

The dissertation attempts to examine the causal mechanisms and to capture the complexity of regulatory decision-making. Small-N studies are particularly useful in the absence of a strong theory, which is currently the case in the IPE of investment banking. Quantitative research tools are inappropriate for this scientific enquiry as they omit most contextual factors and aggregate variables into single indices so that scholars end up with fewer independent variables and more degrees of freedom (George and Bennett 2005). By contrast, the thesis is interested in examining if and how a variable caused a certain outcome rather than calculating *to what extent* it caused the outcome. It would also be incredibly difficult to come up with a way to measure complex explanatory variables, some of which build upon social norms. Moreover, case study research allows me to address the issue of 'equifinality', i.e. the possibility that different combinations of explanatory variables can cause the same outcome. The process-tracing method ensures that the causal pathways leading to the dependent variable are identified and tested. Process-tracing is as simple as it is a powerful tool for qualitative case study research. It essentially uses original sources, media coverage and the data from the semi-structured interviews to establish causal relationships. In other words, it traces the process of regulatory decision-making from start to finish. The process tracing exercise for the so-called repeal of Glass-Steagall, the passage of the Gramm Leach Bliley Act of 1999, actually starts in the early 1960s and in total spans four decades. The process tracing for the passage of Gramm Leach Bliley includes thousands of pages of media reports, court documents and decisions –

it is so vast and complex that the academic story of Glass Steagall's repeal is being told in three separate chapters.

As part of the within-case analysis, the author uses the method of process tracing to work his way back up to the dependent variable inductively. The author started by ascertaining all relevant speeches, testimonies, legal documents and newspaper articles, examining these in order to identify which factors caused policy decisions that resulted in the dependent variable. Process tracing allowed the establishment of a chain of causalities from start to finish. At every stage of this chain, the author checks and verifies the necessary conditions for causing the respective outcomes in order to build up a seamless, chronological and logical chain. This chain allows tracing and linking up of the explanatory variables to the dependent variable.

Given the concentration of investment banking activity in only two Tier I centres (London and New York), and at most three to six additional Tier II/III financial market places (Amsterdam, Frankfurt, Tokyo, Singapore, Chicago and Hong Kong), an in-depth qualitative analysis is the only appropriate research design as a result of the lack of a sample group greater than eight to ten. In addition, US investment banks make up most of the market activity – both in the US and London.

Besides conducting in-depth within-case analyses, the thesis also compares the cases with each other. Cross comparisons help identify patterns of similarity and differences which in turn allow statements about the causes and consequences of the dependent variable that are not generalisable as such, but serve as a stepping stone for theory-building in the IPE of investment banking. With small N case study designs, it is impossible to make generalisations that hold the test of falsifiability. However, as George and Bennett point out, they serve an important purpose in developing theories which then can be tested by means of quantitative analysis thereafter (George and Bennett 2005).

3.3. CONDUCTING SEMI-STRUCTURED ELITE INTERVIEWS

3.3.1 The Need For Interviews

Gathering data about decision-making at the highest echelons of investment banking – both from an industry perspective as well as from a government's perspective – is challenging for two main reasons:

First, the public reporting about regulatory changes in investment banking is targeted at financial experts (such as the articles in the Wall Street Journal and the Financial Times) or lawyers (such as the updates from the various law-firms in New York City). The complexity of financial regulation not only requires a legally or financially trained mind, it also necessitates a certain basic interest and understanding of the material at hand. It is thus no coincidence that the vast majority of media outlets struggle to wrap the rather dry facts about investment banking regulation into an attractive story for their readers without compromising on quality and content. Several important regulatory decisions were incorrectly reported in even the most prestigious newspapers in the world, such as the New York Times's articles on the SEC decision with respect to the net capital rule (Labaton 2008). However, rather than simply focussing on the role of the media and its faults, it also reflects poorly on the industry's and government's quality and efforts of communicating about regulatory changes. It either highlights an unintentional inability of the investment banking community to communicate effectively or a deliberate attempt not to decipher the complexity of regulatory decision-making and its impacts on a wider audience. However, given the relatively negative reporting about investment banks in the media, which is most likely not in the banks' interests, it is probably safe to assume that it is extremely hard to manage their public relations. A key consequence of this relationship between the investment banking industry and its regulators with the media is the simple fact that there is relatively little reporting on the behind-the-scenes facts, the reasons and incentives behind certain regulatory outcomes that go above and beyond the surface in mainstream media and rarely touch upon political economy aspects in the experts' reporting.

Second, and as a consequence of the first point, extremely little has been written about investment banking in the field of IPE. In addition, researchers will find it challenging to identify the ("real") motives of regulatory decision-making in the court filings, the lobby group communications and other public accounts alone. These accounts are very technical, which makes them hard to digest for researchers without a background in law *and* finance. In addition, the publications mostly do not address or reveal those aspects relevant to IPE researchers, such as who gains what and who receives more power? The publicly available data is thus incredibly sparse both from direct sources and in academia.

3.3.2 Selecting Elites

Given these two reasons, one of the most reliable methods of gathering information about regulatory decision-making in investment banking is through interviewing the key people involved. This target audience essentially consists of elites: people who occupied, or are still in charge of, key functions within the investment banking community - at investment banks, law firms, lobby groups and public authorities, such as regulators. The process of identifying and then selecting a relevant group of interviewees was important, as the quality of interview data was strongly dependent on the interviewee having had a sufficiently elite knowledge of investment banking regulation. It would have been insufficient to interview people in highly technical, yet not senior positions or in mid-managerial functions as they often (i) lack an appropriate macro perspective ('big picture') and, more importantly, (ii) would not have been privy to the key meetings and confidential conversations at the most senior levels. Irrespective of their workplace, the author focussed on interviewees who were at the highest level of their organisation, i.e. the executive board, senior partner circle or head of their organisation.

Before selecting interview partners, the search was narrowed down to four key groups or clusters within the investment banking community. They are, in order of importance:

(i) Regulators;

(ii) Law firms;

(iii) Lobby groups;

(iv) Investment banks.

Regulators are clearly the most important group within the community. They execute the laws, regulate and supervise the industry and often act as discussion fora for the industry to exchange views, worries as well as advice. Moreover, they can also steer, interpret and change regulation without the legislative. In sum, regulators are incredibly powerful by virtue of having the mandate to supervise their industry. For the dissertation, the author selected the following regulators and secured the corresponding interview partner(s):

- The US Federal Reserve System
    - Member of the Federal Open Market Committee & Head of a US Federal Reserve Bank
- The US Securities and Exchange Commission
    - SEC commissioner;
    - Director of a SEC Division
- The UK's Financial Services Authority
    - Board level members
    - Heads of division
- The International Organisation of Securities Commissions
    - Member of the IOSCO Technical Committee
- The UK government task force dealing with investment banks and the fallout from the financial crisis of 2007 – to date: head of this entity (further details would compromise his/her identity)
- The US White House:

  - Former Deputy Attorney General

- The US Treasury Department:

  - Senior member of the financial regulation unit
  - Assistant Deputy Secretary

- Congressional Research Service:

  - Senior member of staff on regulatory issues

- Bank of International Settlements:

  - Former General Director

Law firms seem an unlikely candidate to come out as the second most important group in the community of investment banking regulation. Nonetheless, they play a pivotal role in regulatory decision-making, especially in the United States. They perform three services that are essential for the industry as a whole: firstly, they can support the government in drafting new laws as well as help represent it in legal cases; secondly, many law firms also help investment banks in their day-to-day activities to ensure that they understand and keep within the regulatory requirements; and lastly, they act as lobbyists and represent the investment banking industry during public consultative processes with respect to regulatory changes. Because of the complexity of financial regulation and potentially extremely costly consequences in case banks get legal requirements wrong, one should not underestimate how much of investment banks' activities is driven, and at least always monitored, by law-firms. Class-action lawsuits as well as SEC investigations can severely disrupt an investment bank's operation, dampen its share-price and divert senior management's attention from its core business. Law-firms thus take an important role in investment banking, especially in the US where investment bankers delegate many more tasks to lawyers than in the UK. The author selected only the top law-firms in the US and the UK, i.e. those belonging to the 'magic circle'. Thereafter, the author focused on their financial institutions and regulatory practice and approached only senior partners or general counsels which have had more than 25 years of professional experience and were involved in some of the most important transactions and regulatory decisions in investment banking. Since most of the interviewees are heading the investment banking or financial regulatory practice at their law firm, which is a small circle of people, the below list will only identify the law firm by location, but not name:

- New York City & London:
  - Head of financial institutions practice at a top international law firm;
  - Head of financial institutions practice at a top international law firm;
  - Head of financial institutions practice at a top international law firm;
  - Senior Partner specialising in the SEC at a top international law firm;
  - Head of financial regulation practice group at top international law firm;
  - Head of financial regulation practice group at top international law firm;
- Washington D.C.:
  - Head of financial institutions practice at a top international law firm;
  - Head of financial regulation practice group at top international law firm;
  - Head of financial regulation practice group at top international law firm;
- In addition, one US Supreme Court judge agreed to be interviewed.

Lobby groups take up an important part in representing and communicating the positions of their clients effectively in front of legislators, regulators, the government and the media. Many lobbyists have a legal background and, given the sheer legal technical knowledge need to opine on financial regulation, they need to be well versed in highly complex details. UK and US lobby groups vary tremendously in their modus operandi and staff profiles. By and large, US lobby groups in the field of financial regulation are less focussed on PR – as many general UK lobby groups are – and are usually made up of former staffers to Congresswomen and Congressmen, former regulators as well as senior lawyers. Most of Washington D.C. revolves around politics and "the Hill" is made up of countless lobby groups and associations, all of which are an integral part of US policy-making. One of the greatest myths surrounding the work of lobbyists is the idea – time and again portrayed in the media and academia – that lobbyism is a blunt game of tit-for-tat between politics and business, largely focussed on campaign money, power and favourable regulatory outcomes. This, however, paints a severely distorted picture of reality. The dissertation does not argue that financial contributions are unimportant; on the contrary, financial support and the promise to create jobs and make investments are important and help lobbyists obtain access to law-makers. However, reducing lobbyism to a pure financial dimension ignores the complexity of lobbyism and the fact that there are numerous financially powerful lobby groups that compete with each other – across partisan lines and geographies – for influence on the Hill. The data from the dissertation's interviews as well as secondary sources paint a picture in which lobbyists' money does play a role, but is certainly not the key determinant for lobbyists' success (however defined) and should be more seen as an "investment" in what it takes to participate in the "Washington circus". Lobby groups are an integral part of US policy-making as they provide important feedback from the industry on the current and proposed regulation and propose alternative scenarios. In doing so, they give regulators and legislators insights into how regulation affects or would affect their industry. Top lobbyists enjoy privileged access not simply by virtue of money, but also the importance of the consumer and/or industry groups they represent, their knowledge and seniority: they have built up their own network of contacts through their career and not vice versa. This is not to say that lobbyists are public servants – they represent particular interests after all; but in doing so, their work needs to be seen in a more holistic dimension that spans both financial contributions as well as expert knowledge.

In the case of investment banking, 'Wall Street' was outspent by other financial service sectors, and the data from the interviews suggest that lobbyism is more centred on communicating the industry's views on very specific, highly technical and/or legal topics of certain aspects of financial regulation. Often, the lines between law firms and lobby groups are blurred, as many lawyers also act as lobbyists for their investment banking clients and register in Congress as such. The author therefore selected a range of top lobbyists some of which worked for a lobby firm, others for law-firms:

- Washington D.C.:
  - Head of one of the premier lobby firms focussing on financial institutions;
  - Head of the financial institutions practice at a top lobby firm;
  - Senior partner at the financial institutions practice at a top lobby firm;
  - Senior lawyer specialised in lobbying for financial institutions at a top law firm.
- London, U.K.:
  - Board member of one of Europe's most important industry associations of the financial sector
  - Head of a top PR firm.

Lastly, investment banks themselves are naturally one of the key players. However, one has to make a clear distinction between investment bankers and investment banks. It is probably fair to assume that the overwhelming majority of investment bankers is neither interested in regulatory decision-making, nor has an intricate knowledge of it. This is not a criticism. On the contrary, one cannot expect investment bankers to understand those aspects of financial regulation that do not influence their functions, in much the same way as surgeons are not experts in medical law. Selecting a group of investment bankers which was both capable of answering my interview questions, but also had the time for an interview was enormously difficult. Through former work contacts, the author managed, nevertheless, to track down some of the most senior figures in the global investment banking industry:

- Global Co-Head of the Financial Institutions Group of the one of the world's largest investment banks – based in London;
- Managing Director in the FIG Practice of one of the world's premier investment banks – based in London;
- Team Leader of the FIG Practice for Europe at a top international investment bank – based in London;
- Head of the FIG Practice of a Tier 1 investment bank – based in New York;
- Managing Director, FIG Practice of a Tier 1 investment bank – based in New York;
- Head of one the world's largest hedge funds, former investment banker – based in London.

Having identified these four groups from which to select interviewees, the response rate to interview requests varied widely between them. The respective response rates are:

- Regulators: 90%
- Law Firms: 50%
- Lobby firms: c.33%
- Investment banks: c.5%

3.3.3 Scheduling And Conducting Interviews

A chapter on research design should also inform its audience about how an academic researcher can set up and conduct interviews with elites. It should advise on how to avoid common pitfalls, which in turn is a must to achieve sensible response rates. At the risk of sounding profane, any academic should be aware of the enormous cultural gap between academia and the world of investment banking. Whilst it is relatively easy in today's world to gain the contact information of many key regulators, lawyers, lobbyists and bankers via the public domain, it is actually incredibly challenging to draft an appropriate written interview request. It goes without saying that any researcher has to have and utilise official university stationery. This is easier said than done, as some university departments restrict the use of their official paper to full-time academics only. Any letter sent to a top partner at a law firm or a senior investment banker or regulator has to comply with unwritten rules adhering to the same high standards that are common in the business world.

The real challenge, however, is the letter's wording and content. Elites, if they do read letters themselves or have their executive assistants read them on their behalf, are impatient and will give you one brief chance to catch their attention **and** interest. The drafting of such a letter easily took as long as writing a chapter. Besides a brief introduction about oneself and the research project, the author made sure to be precise about why this interviewee was chosen, in what context, how long any interview would take, that all data remained non-attributable and that the author would get in touch with the interviewee's secretary to check whether he/she agreed to the interview. Within two paragraphs, the letter set out the author's as well as the project's credentials and gave all details about the interview's format, length and rationale. One of the most important elements of the letter was the fact that author would keep the lead in getting in touch, rather than handing over the initiative for follow-up to the addressees. This proved to be invaluable as it not only gave me legitimate reason to get in touch, but also allowed me to chase if I received no response.

Once the interview is scheduled, it is obviously important to dress smartly, carry a nice briefcase, not least to fit in, but also to ensure that there is no visual gap in between interviewer and interviewees. The gap in seniority and status between (young) researchers and elites is already so large that researchers should not add to it.

More importantly, professional attire underlines one's seriousness about the research project, and pays respect to the importance of the interview occasion. Finally, those researchers who feel inspired by the thesis to write about the investment banking industry as well should not forget that one's outfit and behaviour are key factors to consider when conducting interviews, especially in an industry where image is important, as is the case in investment banking.

The author chose to conduct semi-structured interviews. The world of academia is far removed from the sphere of investment banking, which in itself is detached from many other real world phenomena. Consequently, researchers have to be careful to 'pick up' the investment banking audience and find a common language during an interview. If researchers do not have a professional background in investment banking, it is important that they become familiar with the dominant cultural norms and industry lingo as the industry itself is fast-paced, rather aggressive and blunt. Asking questions with the right amount of respect, but also cheek is crucial for uncovering interviewees' real opinions and feelings. A common understanding or at least familiarity between the interviewer and interviewee allows the conversation to progress and really dig into those aspects that 'the insiders' (interviewees) would not talk about with outsiders.

Pressing one's research into a corset of pre-defined questions does not bode well with elites. Elites are, by default, not used to being told what to do – neither professionally, nor in an interview context, particularly concerning more delicate questions. Structured interviews risk alienating elites and making them reluctant to talk openly. Moreover, they can be a hindrance to allowing interviewees to really develop their arguments and eventually actually answer the interviewer's questions in any case. Rather than entering interviews with an agenda, the author prepared what he wanted to ask in terms of categories and specific dates. This gave interviewees guidance about the topic of the conversations without constraining the flow of their answer. Whenever they did trail off too much, they could gently lead the conversation back to my topic and agenda. This, however, was done without following a strict game plan or structure.

3.4 THE DEPENDENT VARIABLE

The dissertation asks how, and under what circumstances, significant changes to financial regulation of investment banking occur. More specifically, it focuses on episodes of changes that have led to a decrease in financial regulation or intentional acts not to regulate financial markets.

Financial regulation encompasses various aspects and addresses a range of different user groups: i.e. retail customers, high-net worth individuals, corporate customers and so called market counter parties or sophisticated investors. These user groups enjoy different standards of user protection, ranging from the highest standards in retail (i.e. based on the assumption that all retails users are by default laymen) to the lowest for professional investors or 'market counterparties'. Financial regulation includes product design, codes of conduct – anti-money laundering rules, Know-Your-Customer - as well as macro-prudential regulation.

Referring to the literature review, the concept of 'financial regulation' essentially refers to a set of rules or governance either by the state or the market itself (or both) over the financial industry and its activities. The concept gives no insight about the type of regulation or the actors involved. As such, financial regulation covers a wide spectrum. If we define this spectrum by the degree of formal state supervision and regulation (rather than self-regulation by the markets) then financial regulation ranges from 'strictly' regulated financial markets, such as life insurance, to 'unregulated' or 'non-regulated' financial markets, such as certain derivatives and 'dark banking pools', for which there are no formal governance and regulatory requirements in place.

Because of this wide variance in states' role in regulating financial markets, it is important to differentiate the *concept* of financial regulation from

(i) *type or regime* of financial regulation, i.e. tightly regulated or non-regulated and;
(ii) the *acts* of de-regulation as well as re-regulation.

Whatever type or regime of financial regulation we analyse, financial industries, activities and products and their regulation are the result of deliberate actions by legislators, regulators and the judiciary. In other words, whether a financial market is tightly regulated or not publicly regulated at all is a deliberate act.

As stated before, the dissertation thus focuses on episodes of a decrease in financial regulation – it looks at regimes of financial regulation and acts of de-regulation. The dissertation argues that a decrease in financial regulation can be understood in four distinct ways:

- Firstly, a decrease in the regulatory capital financial institutions are required to hold against their assets. An example would be the introduction of Basel II which allowed commercial banks to decrease the capital risk weights assigned to loans to private sector companies if those had a credit assessment of A- or better (Basel I assigned an across the board 100% capital risk weight to private companies);

- Secondly, a widening of access to financial markets segments in which financial institutions are allowed to operate. An example would be to allow US Bank Holding Companies to enter insurance market activities which was previously seen as illegal;
- Thirdly, a reduction in the administrative and regulatory burden depending on the classification of customers into private customers (i.e. retail), intermediate customers (i.e. small and medium-sized enterprises, local public authorities) and market counterparties (i.e. governments, central banks, regulator's authorised firms, oversees financial institutions). Investment banking clients classified as market counterparties receive a significantly reduced amount of investor protection since regulators regard them as sophisticated. The classification of clients into various categories allows investment banks to reduce the administrative burden considerably; for example, hedge funds are market counterparties and they regularly purchase complex structured products from investment banks without having to go through the advisory hurdles and paper trails retail customers would have to go through (if they were allowed to purchase the same structured product). The classification as a market counterparty thus reduces the risk for the investment bank of being sued for selling an unsuitable product (since it can be assumed that the hedge

fund understand the products without receiving advice); it also reduces the paper trail.

- Lastly, an outright exemption from any regulation for new market segments and/or products other than the financial regulatory standards that apply to the financial institutions as a whole. Here, the over the counter trading in innovative structured products in the United States is an example.

This study specifically examines the macro-prudential regime of financial regulation and excludes aspects of micro-prudential regulation, such as codes of conduct. Moreover, it concentrates on market counterparties, i.e. how financial institutions deal with each other in the market, not with retail customers. The empirical outcome the dissertation seeks to explain is the change in the macro-prudential regulation of investment banking, specifically, instances of a decrease in financial regulation of investment banking activities as discussed above. As such, the dissertation's dependent variable is understood as a loosening of or outright exemption from financial regulation in areas of investment banking. The dependent variable does not analyse micro-specific regulatory issues, such as the regulation of specific investment banking products, investor protection policies or anti money-laundering statutes. Rather, it examines the regulation of investment banks as entities and investment banking markets. The dependent variable focuses on financial regulatory change and not financial regulation as a whole.

Policy change can be defined and measured in a number of ways. In the field of financial regulation, a change in policy can, but does not have to lead to a loosening or tightening of financial regulation; this would be the case when a de facto industry standard becomes a de jure one.

3.5 THE HYPOTHESES & EXPLANATORY VARIABLES

Three explanatory variables were defined prior to conducting fieldwork. Firstly, the thesis predicted that interest group pressure in the form of either lobbying or the 'revolving door' play an important role in financial regulation. Secondly, the thesis regarded the institutional set-up of financial regulation, i.e. the 'rules of the game', such as the US Bank Holding Company Act, as an important explanatory variable. Thirdly, the author believed that the role of ideas in the form of people's ideas about appropriate financial regulation and market conduct would be a key response variable. All these variables are part of an inductive case study design. During the fieldwork and research the author identified an important further explanatory variable, which is part of the role of institutions: the role of the courts. As George and Bennett argue "in case studies, the inductive use of process tracing can turn up unanticipated variables that are directly tied to causal mechanisms" (Bennett and George 1998). In this case, the judiciary, as an institution, can play a significant part in financial regulation

3.5.1 Interest Group Based Theories In IPE And Their Explanatory Variables

As the literature review has shown, economists have developed demand and supply side models that regard regulation as the reflection of rent-seeking of powerful private interest groups made up of rational actors (Stigler 1971). Regulatory capture is a powerful concept that informs the arguments of Steil & Litan, who assert that the Basel Capital Accords were shaped by banks (Steil and Litan 2006), as well as IPE scholars writing about the Wall Street – Treasury Complex which reads like a who's who of the IPE academia: Wade (Wade and Veneroso 1998), Helleiner & Porter (Helleiner and Porter 2009), Underhill & Zhang (Underhill and Zhang 2008) and Cerny (Cerny 1994)). There are three key assumptions that underlie the academic work in the field of private interest group power:

- Firstly, well-organised and financially powerful interest groups can influence regulation by way of campaign contributions so that legislators, once elected, modify the regulatory environment to reflect the interest groups' needs. In the case of investment banking, scholars allege that 'Wall Street's' campaign contributions have led to regulatory capture of US financial regulators.

- Secondly, by virtue of their operating model, market position, customer and product portfolio, interest groups have intricate, sometimes privileged information into their industries. When legislators and regulators evaluate existing regulations and examine the possible impact of new regulation, many academics assert that financial institutions use their information advantage to supply only those pieces of information that support their cause.

- Finally, scholars claim that besides an information advantage and the financial firepower, investment banks also enjoy privileged access to the key decision-makers in the White House and the US Treasury by virtue of these key civil servants having been investment bankers in their former career, and who might return to Wall Street later on. The idea is known as the ‘revolving door’, and academics essentially portray both the current as well as former investment bankers as borderline corrupt. The thrust of their argument is based on the civil servants being lenient, if not favourable to Wall Street banks in return for them going back into investment banking and attaining a (fantastic) senior position.

3.5.2 The Relationship Between Campaign Contributions And Regulatory Outcomes

The thesis started to explore how and to what extent investment banking campaign contributions could influence the financial regulation of investment banks. Even the initial results were astonishing.

The costs associated with running for Congress or President are high. Public funds are available for those running for President. Primary matching funds match the first USD 250 of individual contributions on the condition that the receivers accept public spending limits. These spending limits have caused many candidates since the late 1990s not to accept any primary matching funds and to rely on private donations. In addition to matching funds, public funding is also available for the national nominating conventions as well as the party nominee’s general election campaign. Again, receivers of these funds commit themselves not to spend more than USD 50’000 of their own funds; both Romney and Obama rejected any public funding.

Having examined the size of the securities and investment industry's contributions, the sector does not rank within the top ten of industry contribution for the aggregate amount of the period from 1998 until 2012. Indeed, it 'only' comes in at rank 12, which reflects that the industry certainly has had ample financial resources. However, its contributions were smaller than those of eleven other industries, some of which are competitors to Wall Street. From a pure financial firepower perspective, investment banks are not amongst the top contributors despite the media and academia attention they receive.

Looking at Wall Street's campaign donations in more detail, the contributions were made roughly evenly to both the Democratic Party as well as the GOP across the period of time under consideration (Opensecrets.org 2012). This is all the more astonishing as we have had four different US Presidencies, three different US Presidents and seven United States Congresses between 1998 and 2012.

As a result, the thesis believes that no conclusive evidence can be drawn from analysing campaign donations as an explanatory variable at this stage. It is thus not part of the dissertation's analysis. It is rather surprising how much attention researchers and journalists have given to the alleged power of 'Wall Street' by way of campaign contributions without presenting the underlying numbers.

3.5.3 Content – Activity - Pathway

Rather than analysing interest groups through the lens of preferences and financial endowments, the thesis examines interest groups by way of three distinct explanatory variables: the content of lobbying, namely the information they can offer, lobbying as an activity, and lobbying as a pathway.

3.5.3.1 Information: content matters

Imagine this: as a patient, would you expect your doctor to be an expert in his/her field of medical practice and general medicine? The answer to this rhetorical question is obviously 'yes'; in fact, patients have become more like 'consumers' of medical services and are selective about their choice of consultant and hospital. With respect to finance, law, regulation and investment banking, it is also natural to assume that those working in these industries are experts in their field. In fact, most professionals wishing to work at or for investment banks require a postgraduate degree, and a vast number will also have to pass regulatory tests and compliance criteria. Overall then, entry requirements to join the ranks (irrespective of the level of seniority) of JPMorgan, Goldman Sachs, Davis Polk and Cleary Gottlieb are among the highest and most competitive in the world. Corporate lawyers, accountants, PR consultants and bankers within investment banking have to withstand long working hours and enormous time and peer pressure without compromising the quality of their output. It is thus fair to assume that senior professionals within the industry are experts in their field, having worked on dozens of highly complex transactions, been intricately familiar with the ins and outs, the dos and don'ts of investment banking, its dealings and regulation. It appears rather bizarre that IPE scholars accuse these professionals of having privileged information or an information advantage – as a matter of fact, they very well should have it by virtue of their function, seniority and competence! The so-called information advantage could be defined by way of three categories: time, position, content.

First, as their careers span several decades in an industry with one of the highest 'up or out' rates, they belong to the few senior executives that 'survived' and rose to the top. During their careers, they have been able to collect a wealth of experience and information that is therefore rare and highly valuable.

Second, they are usually part of their firms' executive committees that have direct dealings with other C-Suites, top regulators, the government and legislative [?].

Finally, and as a result, of the previous two points, senior investment banking professionals have accumulated a wealth of knowledge that is hard to match and even harder to replicate. Whilst this could be said for all senior professional jobs across all industries, investment banking is a little different in that the situations during which one learns and applies one's skills – i.e. M&A deals, complex trading vehicles etc. – often push the intellectual (and legal in the sense which transactions, structures etc,. are permissible by law) boundaries of all actors involved, and are thus not easily replicable, as the industry is highly innovative.

Explanatory variable I: content is key for interest groups

From a researcher's perspective, senior investment banking professionals can thus be seen as having privileged information on their industries *by virtue* of their careers. As an explanatory variable, they thus have superior content – the very aspect IPE scholars criticise is actually a by-product of their careers. When legislators and regulators evaluate existing regulations and examine the possible impact of new regulation, they depend on industry information. Even with research assistance, such as the one provided by the Congressional Research Service, staffers and information analysts, the regulatory landscape is so complex that changing it may give rise to unintentional consequences. Industry information and feedback is thus essential for ensuring that regulators as well as legislators fully understand the potential repercussions – good and bad – of regulation.

The Expert Information Hypothesis

Interest groups fulfil an important role for legislators and regulators, as they provide expert opinions and feedback on existing regulation and potential future changes. Besides representing potentially significant industries and thus domestic economic interests, it is because of the *information* they have that they are invited to opine in front of Congressional and Westminster Committees.

3.5.3.2 Lobbying: The activity

One of the most infamous and most talked-about interest group activities is lobbying by way of campaign contributions to legislators. However, analysing this link is challenging as previously noted. Firstly, campaign contributions really only matter in US politics, yet not to the same extent in Westminster, where parties also receive substantial taxpayer funding. Secondly, the investment banking industry competes with other financial industries, such as insurance, asset management, thrifts and commercial banks for attention and legislative changes, and it is not at all clear whether investment banks have a greater and more important voice than say community banks, thrifts or commercial banks. In addition, investment banks simply do not have grassroots movements as other financial industries do, such as cooperative banks.

Claims about the lobby power of Wall Street are not only difficult to verify, but also have to be seen in context with other very powerful (and rich) industries, such as Silicon Valley, the Oil & Gas industry or Sugar Farmers. The thesis expects that even the lobbying to Congress is far less blatant and effective than people commonly assume. Moreover, regulators cannot be lobbied via financial contributions. The only form of lobbying the industry can legally do is to inform regulators about the impact of their decision-making. Finally, there is a logical flaw in most IPE scholars' lobbying thesis. It is this: if the investment banking had such a strong grip on Washington and Westminster, why would they still need to lobby? In other words, if the key decision-makers are already "captured" by Wall Street, surely they do not need to be lobbied as well?

Lobbying is better understood as the ongoing provision of key information to regulators, the public and legislators alike, all of whom depend on external data for the drafting of laws, amending existing regulations and analysing current events. Much of the content of these exchanges is freely available to the public and thus transparent: information provided during regulators' comment periods, hearings in front of Westminster or US Congress committees.

Content – as highlighted before – is important, but this information needs to be relayed to decision-makers if interest groups want to have an impact. The thesis argues that the activity of presenting and exchanging information is *the* main activity of interest groups.

Explanatory variable II

Lobby groups' main activity is the **provision of information** to legislators and regulators. The information content is often highly complex, but also often publicly available.

The Provision of Information Hypothesis

The activity of lobbying is part of the information flow between investment banks, the industry and the regulators, and should not be seen as a key determinant in policy outcomes, as it is the content that is important and not the act of lobbying per se.

3.5.3.3 The pathway of lobbying: 'the revolving door'

The majority of academics in IPE simply assume that by virtue of people moving from the investment banking industry to a regulator, and vice versa, that there has to be some form of capture (of the regulator, not the industry), if not an entire 'Wall Street-Treasury Complex' (Bhagwati 1998). The thesis sets out the weakness of this literature in my review and highlights that the revolving door could be a necessary, but certainly not a sufficient condition for capture. One needs to understand people's motives for moving jobs by way of interviews before drawing any conclusions as so many researchers do. It is rather shocking if we think about what the predominant 'revolving door' thesis actually argues: for industry insiders to capture parts of the civil service, their only motive would have to be financial gain. The simplest and most powerful way of proving the capture hypothesis is this: find a clear instance where an industry professional joins a regulator or where a person who has always been a regulator, either changes existing regulation or passes regulation that would not only significantly benefit the investment banking industry, but also provide that person with a lucrative job in that industry which he or she could not have attained otherwise, leading to personal gain. Ultimately then, it would be these personal financial pay-offs that are one of the key explanatory variables for regulatory outcomes that favour the industry.

Before conducting my fieldwork, the author searched extensively for examples of the capture thesis and examined even extreme cases in which traders or bankers committed actual crimes, such as money laundering or unauthorised trading activity. There are many instances of such financial crimes, such as insider trading, unauthorised trading, market conduct violations, but the author has not found a single incident that would prove the capture thesis right.

The dissertation's case studies examine whether revolving doors played a role. The thesis expects to find less clear-cut situations, i.e. people may not have come or gone into Wall Street, but other positions, such as law firms, Senate staffers etc. In the case where Wall Street professionals leave their handsomely paid jobs and join regulators – the thesis expects that they are doing so not to manipulate regulation in the industry, but as a form of public service. Conversely, the author expects that regulators join the private sectors because they have outstanding CVs and not because the industry regards them as having been lax. In both cases, current IPE scholarship regards the revolving door between Wall Street and Washington as one the key pathways of industry lobbying. The thesis aims to show that this is incorrect: First, as mentioned before, there seems to be a very limited revolving door between the US Federal Reserve Banks (which have a strong *esprit de corps*) and Wall Street; second, for a revolving door to be effective at actually impacting policy outcomes, it would have to be a revolving door of the very top executives and regulators; third, US Supreme Court judges have tenure for life and the vast majority (if not all) retire after their position at the court.

Explanatory variable III: the revolving door as transfer of knowledge

As an explanatory variable, the ‘revolving door’ is not an activity of lobbying, but an important pathway of exchange and transfer of knowledge between the elites of public service and the top executives of the investment banking industry. Gaining insights from market participants is key for regulators’ understanding of the markets and hence their regulatory response to it and vice versa.

The revolving door hypothesis

In cases where a revolving door between regulators and regulated exists, it does not lead to ‘capture’, but is a key function in enhancing the information flow between the two, thereby adding to the financial system’s stability.

3.5.3.4 Regulators can alter the ‘rules of the game’ irrespective of their statutory authority

When analysing episodes of regulators proposing rules that could cause significant regulatory change, regulators did so at times without having the statutory authority to do so. In other words, rather than being the guardians and executors of the rules of the games which legislators defined, regulators could establish *new* rules and thereby bring about regulatory change without legislative change.

As the thesis will show, the success or failure of regulators' own regulatory initiatives does not depend on whether they have the statutory authority in doing so, but whether it is in line with the zeitgeist – the dominant market ideology at the time - and can be upheld in the courts in case the initiatives are being challenged. In both cases though, regulators can actively cause regulatory change without legislative change: in the thesis's case studies, regulators stepped in and amended regulation when there was a Congressional impasse (as was the case with the Federal Reserve and Glass Steagall) or when there was an urgent need to act before Congress could pass respective laws.

These regulatory changes do not always stand the test of time, even when regulators are acting within their statutory authority. In the case of the Federal Reserve, it succeeded with its regulatory change as it was acting within its statutory authority. However, the CFTC, who also acted within its statutory authority, failed completely. The thesis will analyse the reasons behind these two specific examples. When regulators act outside their statutory authority, they expose themselves to being potentially challenged in the courts, which then determines whether or not they will succeed in bringing about the regulatory change. In case of the CFTC's Swap Policy Statement (CFTC 1989), the commission lost out on its regulatory change when the US Courts ruled against it. However, the SEC's CSE Programme succeeded despite being voluntary and outside the SEC's statutory remit. Clearly then, there must be other factors involved that determine whether or not the regulatory change brought about by the regulators themselves succeeds or not.

Explanatory variable IV: regulators can change the rules of the game with or without statutory authority

As an explanatory variable, regulators can alter or set new regulatory rules without necessarily having the statutory authority to do so. Whether or not they will be successful in that depends on whether their rules are being challenged in the courts, as well as whether their rule change is in line with a broader regulatory as well as ideational consensus.

The statutory authority hypothesis

Regulators can actively establish new sets of financial regulation, and their success or failure in being successful or not is not necessarily related to their statutory authority. In other words, regulators can change the rules of the game without having a legislative mandate.

3.5.3.5 The judiciary: regulatory change by court order

One of the most overlooked explanatory variables in IPE is the role of the courts. Of the three powers of the state, the judiciary, is by its very nature both independent and beyond any lobbying influence in a modern liberal democracy, such as the UK and the US. The most surprising factor during the research was the role of litigation. The idea that you can have regulatory change without legislative change is difficult to grasp at first. Having examined thousands of Federal Reserve and US court documents and publications from the American Bankers' Association and the Securities and Investments Association, it became clear that many IPE scholars in finance overlooked the significance of litigation. The courts' constitutional independence, especially at the higher end of the court hierarchies, elevates them above any lobbying and interest group pressure.

Explanatory variable V:

As such, the courts are one of the key institutional explanatory variables in bringing out regulatory change in finance without being a financial regulator.

The judiciary as a regulator hypothesis

The interpretation of laws by the judiciary can lead to significant regulatory change without any legislative or governmental involvement. In other words, the judiciary as one of the three powers of the state is an important actor in bringing about regulatory change.

3.5.3.6 The role of ideas

Having worked in the glass, steel and marble offices of finance, the author experienced the industry's strong *esprit de corps*, namely that of absolute laissez-faire capitalism: states should be reduced to guaranteeing the laws of the land, especially property rights, and should limit interfering with finance as much as possible, since the industry can regulate itself. The idea of limited government combined with market self-regulation is not new, however the author felt it was particularly pertinent in investment banking, its service industries, such as law and consultancy firms, and even amongst regulators. Having had a junior, yet active role in several important transactions in banking, the author participated in various high-level meetings with regulators, investors and chief executives alike.

The real problem with the regulation of investment banking has been – and still is – the regulatory framework itself rather than specific, albeit spectacular, cases of professional misconduct. Since the establishment of the SEC, the regulation of investment banks had the protection of investors at its core. Accordingly, rules and regulations focussed on important *micro* issues, i.e. the rules and codes of conduct within investment banks, such as know your customer (KYC), anti money-laundering safeguards and market conduct rules. Whilst maintaining these rules, the de-regulation of financial services focussed on largely *macro* issues, the very *modus operandi* and structure of financial markets: the separation of investment from commercial banking, the regulation of OTC derivatives and the amount of capital investment banks have to hold. This caused a bizarre situation overall: whilst the rules governing the relationship between investment banks and commercial banks with their customers have largely not been watered down, the actual markets (and segments thereof) within which investment banking activity was conducted had become ever more de-regulated.

Prior to the onset of the sub-prime mortgage crisis in 2007/8, there has been little to no debate within banks, amongst regulators, let alone in politics, about regulators' lack of macro-prudential supervision, and whether or not the *industry* (nota bene not individual banks, but the industry as a whole) regulates itself effectively. Consequently, the dissertation focuses on the macro-prudential regulation of investment banking and the reasons why policymakers decided not to regulate certain significant market areas. The argument that regulators are always behind the curve and fail to attract the best human capital is too simplistic. Given that the institutional arrangements for the regulation of investment banking are completely different in the UK from the US, yet the macro-prudential regulatory standards for the industry appeared in many cases to be the same, the author expects that people's ideas about what type of regulation was seen as appropriate has been a key variable in bringing about a regime of light touch regulation, de-regulation or even non-regulation. The thesis would describe such a regime as 'embedded laissez-faire-ism' and would contend that it has been a key part of people's understanding of how finance works and how best to regulate it. The thesis expects that policymakers' mind-sets play an enormous role in deciding whether or not investment banks or investment banking markets, such as over-the-counter derivatives, should be able to regulate themselves or not. It is striking that the idea of embedded laissez faire-ism appeared to have cut across political lines as well as countries: both Democrats, Republicans, Tories and New Labour have had faith in market-based regulation. Consequently, the final explanatory variable is

Explanatory variable VI:

Ideas are a key explanatory variable that helps explain why key decision-markers believed that the appropriate regulation of investment banking would be light-touch or market based regulation, and intentionally decided not to regulate or de-regulate parts of the investment banking industry or markets.

The role of ideas hypothesis

People's ideas about regulation are one of the key factors guiding their actions and decision-making in relation to financial regulation.

3.6 CONCLUSION

The thesis seeks to understand and to make a meaningful contribution to the political economy of investment banking regulation in the US. In doing so, it follows a qualitative research design and applies the comparative case study method as it seeks to understand the 'causes of effects'. It has identified five instances of major de-regulation or non-regulation that all had a significant impact on the investment banking industry – the thesis dependent variable. De-regulation can be defined in a number of ways: a decrease in regulatory capital requirements, a widening of permissible financial activities, a reduction in the reporting and administrative burden or an outright exemption from regulation. The small N case study approach allows for an in-depth understanding of the complexities of regulatory decision-making in each of the cases that were selected.

The thesis applied the process tracing method, which helped the author reconstruct the chain of causalities that ultimately resulted in an episode of de-regulation. For this, hundreds of testimonies, public statements, newspaper articles, court orders, legislative bills, speeches and academic literature were analysed. In addition, the author conducted nearly forty semi-structured elite interviews with key decision-makers. The case studies were analysed through the thesis's five hypotheses and explanatory variables to fully understand how one arrived at the dependent variable. The final chapter connects the findings from the case studies, discusses their similarities as well as highlights their differences and seeks to build towards a theory of the political economy of investment banking regulation that will hopefully guide future IPE scholarship of investment banking.

Chapter 4

THE REPEAL OF GLASS STEAGALL: THE BEGINNINGS

4.1 INTRODUCTION

The repeal of the Banking Act of 1933 and 1934, commonly known as Glass-Steagall, is said to have been a watershed moment in US financial regulation. The Gramm Leach Bliley Act (GLB) of 1999 (USA Congress, 1999), also called the **Financial Services Modernization Act of 1999**, formally abolished most legal barriers to entry and operation of investment banking, commercial banking and insurance businesses in the US for financial institutions. Telling the story of the causes behind Gramm Leach Bliley and the ‘repeal’ of the Glass Steagall Act is complex and requires separating the material into three case studies. The first case study starts in the 1960s and encompasses a comprehensive process tracing exercise of the early legal and regulatory decisions in the 1960s and 1970s, with which the US Supreme Court provided interpretations of the meaning of Glass Steagall that would subsequently set the scene for its de facto demise. The second case study provides an in-depth process tracing analysis of the Fed’s regulatory decision-making during the Volcker years and the organisation’s increasingly uneasy position of further blurring the lines between investment banking and commercial banking in the absence of a new bill passed by Congress. Interestingly, the Board of the Fed itself became divided on this issue towards the end of Volcker’s rule. The last of the three case studies covers the Fed under Alan Greenspan. Under his reign, as the ‘Rock star of Central Bankers’ the Fed took an increasingly outspoken and aggressive approach towards the issue of (de-) regulatory without legislative change, in part because of Greenspan’s belief in the superiority of market self-regulation, which ultimately culminated in the GLB Act of 1999. The second case study begins at the handover of the Fed’s Chairmanship from Volker to Greenspan, and continues until the actual passage of the Gramm Leach Bliley Act in 1999.

These three case studies seek to refute two commonly held beliefs in academia (and beyond): Firstly, 'Wall Street', i.e. investment banks, pushed for Glass-Steagall's repeal. The thesis will show it was America's Bank Holding Companies that pushed for the repeal whilst the actors on the other side of the fence, investment banks, tried adamantly to defend it, but lost.

Secondly, it is commonly thought that the Gramm Leach Bliley Act was a watershed moment in financial regulation mostly driven by interest groups. However, all three case studies present a rather contrasting picture, namely that litigation-based regulatory change had hollowed out the separating effect of Glass Steagall so that its repeal only gave a new legal basis for the practical realities on the ground. Interest groups might have marginally contributed to this throughout the two decades that it took for the repeal, but were not a driving factor.

The first case study starts with a review of the current research horizon and arguments in the IPE scholarship of Glass Steagall. The chapter then moves to the process-tracing exercise to re-construct the story of the repeal of Glass Steagall dating back to the 1960s. The Federal Reserve Board issued a notice on the 12th of August 1971 saying that it intended to amend Regulation Y. This regulation essentially governs the practices of Bank Holding Companies (BHC) and defines which transactions of the BHC need the Fed's approval. The Fed's notice called for an increase in the list of activities Regulation Y defined as 'closely related' to banking, and to include the activity of investment advisory to a closed-end investment company to that definition.

The trade association of mutual funds in the US, the Investment Company Institute (ICI), challenged both the Fed's interpretation and, ultimately, its decision to amend Regulation Y, and decided to take legal action. The Courts accepted ICI's case, but sided with the Board of Governors in the final level of jurisdiction. The three case studies will uncover that it was this Fed interpretation and subsequent court ruling that ultimately paved the way for the gradual, de-facto erosion of the separation between commercial and investment banking. The Courts would define the separating line between investment banking and commercial banking activities not between the investment banks or commercial banks, but **within** the legal entities of a Bank

Holding Company (BHC). This decision was as simple as it was radical, and would shape the future of the global investment banking regime as we know it.

The three case studies show that the Federal Reserve Board of Governors chose to interpret the Glass Steagall Act in ways that it believed would legally allow Bank Holding Companies to re-enter investment banking activities. Over a period spanning two decades, the Federal Reserve would steadily test and stretch its interpretative room to manoeuvre within Glass Steagall. However, it was up to the US Courts to rule whether the Fed's interpretations were permissible or not. The role of the courts in the story of the long road to repeal is one that has never been told before in the IPE of finance, and which should invite lively debate within which other important events in the IPE finance courts played a role that has not yet been fully discussed.

4.2 THE IPE LITERATURE ON THE REPEAL OF GLASS STEAGALL

Both case studies benefit from a short and focussed literature review, as the current research horizon in the IPE of Glass Steagall is riddled with inaccuracies. The following paragraphs focus on the relevant scholarly pieces in IPE on the repeal of Glass Steagall. The overwhelming majority of academics make claims about the power of 'Wall Street' as an industry and interest group, and regard the repeal of Glass-Steagall as a result of investment banking's sway over legislators. Most of the evidence presented to support these claims is either anecdotal or remains empirically unsubstantiated (e.g. Helleiner, Bello, Underhill, Zhang). Only a minority group, which consists, to the author's last count, of less than a handful of scholars in IPE, seriously engages with the underlying data and understands that Glass-Steagall was not simply 'abolished' by the US Congress in 1999.

According to Helleiner (Helleiner, 2011), 'Wall Street' 'captured' its regulators and successfully lobbied for the repeal of the Glass Steagall Act. The argument here is that the repeal of Glass Steagall in 1999 was a momentous occasion and carried significant consequences. Helleiner asserts that it was the investment banks, i.e. 'Wall Street', that lobbied for the repeal. Helleiner, Underhill & Zhang (Underhill & Zhang, 2008), Bello (Bello, 2006) and Baker (Baker, 2010) all allege that a "Wall Street - Treasury Complex" exists because of a close tie between Washington and Wall Street by virtue of a revolving door of key staff. Baker emphasises that "financial regulatory capture was most pronounced in the Anglo-American heartland of the global financial system" (ibid, p.649). He asserts that "the general trajectory of reform […] was entirely congruent with the *banking* industry's wishes" and lists the repeal of Glass Steagall as well as the SEC's CSE programme as examples (ibid, p.652). The Deputy Director of the OECD Directorate for Financial and Enterprise Affairs, Blundnell-Wignall, argues that "US banks and or investment banks supported and lobbied the US authorities first to remove Glass Steagall in 1999, move to new SEC rules in 2004: and to adopt Basel II as soon as possible" (Blundell-Wignall, Atkinson, & Lee, 2008, p. 5).

The three case studies will show that the aforementioned authors' claims about the repeal of Glass-Steagall are not based on empirics and that they confuse investment banks with commercial banks. By way of process-tracing hundreds of documents, court hearings, newspaper articles as well as elite interviews, the three case studies on Glass-Steagall argue that the repeal was not against the investment banks' will and that for from lobbying for it, they lobbied for keeping Glass-Steagall intact. Moreover, the cases will prove that it was the US judiciary and the Federal Reserve that provided the legal basis for commercial banks – i.e. Bank Holding Companies – to re-enter investment banking activities. Finally, the case studies on the SEC highlights that it was the process of European integration that forced US regulators to act and it was certainly not US investment banks which lobbied for the 2004 SEC rules. In a way, the case studies on Glass Steagall's repeal provide IPE scholars with a wealth of data that unearths the actual driving forces for its repeal. And it was certainly not US investment banks.

Unfortunately, many IPE of finance academics, particularly the ones mentioned in the paragraphs above, relied heavily on secondary sources for their research without checking whether or not these references are factually correct. Even more unfortunate, this has established a relatively large, but self-referencing body of work in IPE of finance which has perpetuated inaccuracies about "Wall Street" and investment banking and has provided little to no new scientific insights.

Why do these issues matter?

One of the driving forces for this thesis is to provide a better understanding about investment banks and their political economy. The thesis is not an end in itself, but wishes to guide future research so as to enable a more thorough appreciation of investment banks and how to more effectively regulate and govern them. One of the great ironies coming out of this research is that the US investment banks were far from being in the driving seat and actually had to adapt themselves to new regulatory realities created by other protagonists, such as the US Federal Reserve or the European Commission. Appreciating complex causal mechanisms driven by intended (EU consolidated supervision of conglomerates) as well as unintended consequences (hollowing out of Glass Steagall) is absolutely key for today's as well as future policymakers and regulators.

When comparing the empirically based research of this thesis to the current state of scholarship, it is surprising how sloppy, and sometimes even negligent many IPE of finance academics are in presenting their beliefs about and attitudes towards investment banking as facts. Moreover, it is not simply a matter of mixing up names if one equates investment banks with commercial banks because both are a 'bank'. As the thesis shows, investment banks and commercial banks are completely distinct types of operational entities; each is governed by different laws, supervised by different regulators and operates in distinct markets. IPE scholars, especially the group that focuses on the IPE of finance, ought to be familiar with these terms and definitions. Incorrect research can easily become the source of reference for non-IPE academics, politicians and the media, thus further building up an aura of factual credibility.

Two publications stand out in that their arguments rest on empirical foundations. Firstly, Abdelal's book *Capital Rules* examines the causes and the consequences of liberal rules for global finance (Abdelal, 2007). Abdelal undertook considerable archival research and interviewed elites across different countries and industries. His results directly contradict most of the mainstream ideas about financial globalisation in academia. On the subject of the 'Wall Street – Treasury Complex', he argues that "there is, remarkably, almost no evidence to support this conventional wisdom […] instead Treasury policymakers were are best indifferent to the capital liberalisation amendment, and some senior officials even opposed its progress [whilst] Wall Street was unambiguously against the amendment" (ibid, p. 13). As the thesis sets out in the literature review, Abdelal's built his own dataset and did not rely upon the IPE of investment banking body of work that is (and becomes through doing so) self-referencing and lacks a sound empirical back-up - Helleiner and Underhill broadly fall foul of this.

Secondly, Suarez and Kolodny's journal article *Paving the Road to "Too big to Fail": Business Interests and the Politics of Financial Deregulation in the United States"* is one of the first, if not *the* first, work in IPE to sketch out some of the complex history of the Gramm-Leach Bliley Act with a focus on the interest group coalition building in the financial community (Suarez & Kolodny, 2011). The authors examine the interests and alignments of the various financial sector lobby groups, in particular the American banking, investment banking and insurance industry. Suarez and Kolodny argue that Glass Steagall was ultimately only repealed when all three financial lobby groups jointly lobbied for legislative change. The journal article partly depicts the long road of the Glass-Steagall repeal, and shows that the lobby of 'Wall Street' was neither in a position, nor was it their preferred option at all times, to break down the Glass-Steagall barriers singlehandedly.

However, the article sheds no light on two key factors of the repeal: first, the authors cannot explain *why* the Fed decided to allow commercial banks to re-enter investment banking activities starting in 1987. This is one of the most important pieces of the puzzle. They simply assert "in a puzzling decision, the Fed – which was still under the chairmanship of Paul Volcker – granted the banks' [commercial banks] request as longer as the securities activities did not exceed 5% of the subsidiary's total revenue" (ibid, p. 85). But it was exactly this decision that changed the regulatory landscape dramatically, irrespective of any lobbying by various financial interest groups.

A second major shortcoming in their research is the lack of analysis of / failure to analyse the role of the courts. These three case studies will argue that the repeal was not simply a case of industry group alignment. Rather, the judiciary played a critical role in bringing out regulatory change without legislative change, and this independently of any interest group influence – be this informational or financial.

The following three case studies seek to fill these important gaps in the current academic research whilst also providing the IPE community with in-depth, empirical evidence on the complex journey that ended with the repeal of Glass Steagall.

4.3 THE UNINTENTIONAL BEGINNING OF THE REPEAL OF GLASS STEAGALL IN THE 1960s

Advisers to closed-end investment companies

The Gramm Leach Bliley Act of 1999 repealed the Glass-Steagall Act of 1933. The US Congress provided the legal basis for the repeal, yet in practice, the US legislative lagged decades behind established market practice. This first case study highlights that the borders between commercial and investment banking had become porous over time, starting as early as the 1960s. It examines the reasons behind it and will point towards the consequences in what are discussed in the subsequent case study.

The roots of Glass Steagall's repeal are to be found in a complex court battle that ended in 1971 with a decision of the US Supreme Court: the Investment Company Institute v. B Camp National Association of Securities Dealers Inc. (Supreme Court of the United States, 1971). This case, which does not involve the Federal Reserve Board, is completely unknown to IPE scholarship.

What happened?

In 1963, the Office of the Comptroller of the Currency (OCC) ran a public consultation process requesting suggestions on ways to better the regulation of national banks' trust activities. By way of background, Congress transferred the jurisdiction over the majority of trust activities in 1962 from the Federal Reserve to the OCC without, however, making any changes with respect to the content and scope of their regulation. In order to accommodate this transfer of supervisory powers, the OCC established a new mantelpiece for the Fed's regulation and called it 'Regulation 9'. Under the auspices of the Fed, collective investments of trust assets were only allowed for true *fiduciary* purposes whilst any type of trust activity of national banks was strictly prohibited. In the eyes of the Fed, banks should not operate common trust funds as investment trusts. Banks should neither attract customers' money in that way nor be involved in the sale of participations in these funds to the public as investments (Federal Reserve, 1940); see also (Federal Reserve, 1956). During the OCC consultation, several commercial banks proposed to allow national banks to offer and operate managing agency accounts, which was tantamount to managing investment trusts, which was itself an activity seen as typically done by investment banks. The OCC concluded the consultation and decided to change Regulation 9 in 1963 to allow for these activities in stark contrast to the Fed's old regulatory regime. Two years went by without any movements: no national bank entered the managing agency business. The situation changed dramatically in 1965: a predecessor to today's Citi Bank, the First National City Bank of New York, asked the OCC for approval to operate the collective investment of managing agency accounts (i.e. similar to an investment trust and hence investment banking). The OCC granted approval and First National City Bank of New York started to roll out collective investment services. Customers could thus invest between USD 10k and USD 50k in the bank's funds, in return for which they received 'units in participation' relative to their investment, which the investment banks regarded as equity. All customers had to authorise the bank as their managing agent and the units of participation were freely transferable and redeemable to anyone part of this agreement. The fund was registered as an investment company under the Investment Company Act. First National City Bank of New York was not only the underwriter of the fund's units of participation, but also the custodian, asset manager and investment advisor. In all but name, the bank essentially started an asset management business similar to those of investment banks. Competing national banks regarded these investment fund activities as a differentiating factor and as an additional source of income. They, too, started to draw up plans of their own so as to convert customers and/or customer funds from the investment banking industry on to their balance sheets.

Confronted with the potential mass entrance of national banks into the investment fund business, the Investment Companies Institute (ICI) - one of the industry group representing the investment banking community - cried foul and took the OCC to court. The ICI argued that the OCC decision was in violation of Section 16 and 21 of the Glass-Steagall Act. In particular, the ICC referred to Section 16, which stipulates

> Dealings in investment securities by a member bank are limited to the purchase and sale of such securities, without recourse, solely upon the order and for the account of customers […] and no member bank shall

> underwrite any issue of securities (Federal Reserve Bank of New York, 1933, p. 9)

and section 21 which states

> It is made unlawful, after a period of one year, for any person, corporation or other organization engaged in the issue, underwriting or selling of securities to receive deposits subject to check or to repayment upon presentation of a pass book or certificate (ibid, p. 12).

In doing so, the ICI asserted that the purchase of stock by a bank's investment fund was tantamount to the purchase of stock by a bank for its own account, and thus in violation of Section 16. The ICI continued that Section 21 forbade deposit-taking banks to be engaged in the securities business, whether for retail, wholesale, underwriting, selling, or distributing purposes, which the ICC contended that the creation and operation of investment funds by banks was (Supreme Court of the United States, 1971). In the first level of jurisdiction, the District Court agreed with the ICC and ruled that the changed provisions in Regulation 9 were invalid under Glass Steagall. The OCC and First National City appealed, and the US Court of Appeals for the District of Colombia Circuit overturned the earlier ruling stating that the regulation was in line with the OCC's statutory authority. The ICC appealed in turn and was granted certiorari by the US Supreme Court.

Why is this relevant?

The securities and the commercial banking industries had gone their separate ways for the most part since Glass Steagall in 1933, and had largely not encroached on each other's turf. This dispute signalled a sea change in that relationship, namely from a co-existence to a more confrontational attitude. Indeed, the US Supreme Court saw it similarly and allowed the case to progress. The judges wanted to consider 'important questions presented under federal regulatory statutes' and believed that the issues that the ICI raised were both 'novel and substantial' (Supreme Court of the United States, 1971). In other words, this case could have the characteristics of a precedent, not only with regard to Glass Steagall and the separation of commercial from investment banking, but also with respect to the statutory powers of US regulators.

The US Supreme Court's acceptance of this case reflects how much this dispute was not a question of differences in legal interpretation, but rather a case that set precedent in that the highest court of the US provided legal clarification of the spirit and language of Glass Steagall and the statutory authority of regulators. The Court opened its hearing with a review of the history of national banks' regulatory regimes, which showed that national banks had operated common trust funds since 1927 and that the Fed had expressly authorised this in Regulation F in 1937. Simultaneously, national banks also acted as managing agents for individual customers. Importantly, however, the Court argued that "the union of these powers gives birth to an investment fund whose activities are of a different character" (ibid). The Court went on to state that "the differences between the investment fund that the Comptroller has authorized and a conventional open-end mutual fund are subtle at best and it is undisputed that this bank investment fund finds itself in direct competition with the mutual fund industry " and that "16 and 21 of the Glass-Steagall Act appear clearly to prohibit this activity by national banks" (ibid). In the view of the Court, Glass Steagall's legislative history gave enough insights as to why the Congress of 1933 took the drastic step of separating investment from commercial banking. Congress felt that commercial banks exposed themselves to various 'hazards' and conflicts of interest when operating in investment banking. The Court recited those hazards at length: they ranged from banks investing their own equity and customers' deposits in 'frozen or otherwise imprudent stock', to corrupting 'disinterested commercial bankers' by incentivising them to sell their bank's investment banking products, and bankers extending loans to unsound companies that the bank owns (ibid). All these hazards, Congress asserted, would limit the function of banks as an impartial source of credit, cause bank depositors losses on their investments and undermine public confidence in the commercial banking system. As a result, the Court argued that

> Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker's

> pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system (ibid).

From a legal and legislative perspective, the Court's verdict was clear. However, the Judges did not stop here, but continued to consider the limits of regulators' statutory authorities. The Court "should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute", whilst the OCC is "charged with the enforcement of the banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws" (ibid). That is to say, the Supreme Court allows and expects regulatory agencies to establish reasonable regulatory statutes as long as they are within the spirit of the laws and to set out the regulator's reasoning for their actions.

The Supreme Court found that the OCC had enacted amendments that were in breach of banking law and failed to provide the Courts, the legislative and the wider public with any legal reasoning behind its interpretation of the law. This, the Court asserted, was "incompatible with the orderly functioning of the process of judicial review" (ibid). It was a damning public rapping of the OCC as a regulator and its work. In the eyes of the Supreme Court, the OCC failed three times:

> First, it "adopted no expressly articulated position at the administrative level as to the meaning and impact of the provisions of §§ 16 and 21 as they affect bank investment funds";
>
> Secondly, it "promulgated Regulation 9 without opinion or accompanying statement" and;
>
> Finally, even in the OCC's report to Congress, it "did not advert to the prohibitions of the Glass-Steagall Act" (ibid). Whilst the Court lauded the OCC's counsel during the litigation hearings, this would be no substitute for an administrative interpretation of §§ 16 and 21 as

> "Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands" (ibid).

The Court concluded, "quite obviously the Comptroller should not grant new authority to national banks until he is satisfied that the exercise of this authority will not violate the intent of the banking laws" and "if he faces such questions only after he has acted, there is substantial danger that the momentum generated by initial approval may seriously impair the enforcement of the banking laws that Congress enacted" (ibid).

The Supreme Court reversed the judgment of the US Court of Appeals for the District of Colombia Circuit, outlawed the OCC's amendments and ruled in favour of the ICI. In doing so, it stopped the inroads of the commercial banking industry into investment banking terrain. The Chief Justice took no part in the decision-making of this case, whilst two Associate Justices, Harlan and Blackmun, dissented. Associate Justices Marshall, Stewart, Douglas, White, Brennan and Black voted in favour.

4.4 ANALYSIS AND CONSEQUENCES

The Supreme Court's judgment in ICI vs. Camp was pivotal in two key areas: first, the Court ruled in favour of the continued separation of investment and commercial banking. However, secondly and most importantly, the judges' verdict was more fundamental than procedural. It was a verdict that expressed a clear discontent with the work and behaviour of the OCC. The Court essentially argued that the OCC failed to live up to its duties and responsibilities as a financial regulator within the US executive and in doing so, *negligently* overstepped its statutory powers. The judges took serious issue with the fact that the OCC failed to provide guidance as to the potential impact of the proposed regulatory changes and that it gave no thought to a detailed review of the existing laws. Moreover, and as a result of the aforementioned, the OCC should have shared any information gathered in this way with the public, but neglected to do so.

As such, the Supreme Court's ruling clearly set out the rules, duties and standards for regulators interpreting and amending existing financial regulation. Examining the arguments of the OCC's counsel during the hearings, it is apparent that the OCC amended Regulation 9 believing that it was compatible with the Glass Steagall Act. The judges expressed irritation that the OCC provided its rationale for changing Regulation 9 when the case was granted certiorari, and that it was not the OCC doing so, but its counsel and thus ex post. The Supreme Court's verdict and conclusions were a public humiliation for the OCC – something it clearly would have wanted to avoid – and an unmistaken warning shot to all regulators: not to curb their statutory powers, but to act within the letter and spirit of the laws and interpret them wisely. As one of the top securities lawyers representing one of the parties in front of court recalls, "the OCC's decision was driven by wanting to be innovative and they did not want to step on other's toes" (WW, 2010). However, "they were really green behind the ears […] and never expected their decision to be so controversial and particularly they did not expect ending up in court; never had it crossed their mind that this was even a possibility" (ibid). When asked whether interest group pressure or lobbying from national banks pushed the OCC into this direction he responded that "it had nothing to do with interest group pressure, but more with their positioning vis-à-vis the Fed […] and don't forget that these were very basic, evolving markets, so there was an element of experimenting here" (ibid). The US Supreme Court acted as checks and balances: it reversed the OCC's regulatory change - essentially a de-regulation from the perspective of national banks – as it failed to provide a sound legal rationale as to how their change of rules was compatible with the laws. The Court did not question the OCC's statutory authority as such, but the way they executed it: "they were certainly made to feel embarrassed, but rightly so since their change in regulation was done haphazardly" (ibid).

4.5 THE OPENING OF THE FLOODGATES: ICI vs. the FRB

The cause of offence

ICI's victory was short-lived, as another potential threat of commercial banks intruding the securities industry's territory emerged: just four months after the Supreme Court's ruling in ICI vs. Camp, the FRB issued a notice stating its intention to amend Regulation Y. The Board intended to amend Regulation Y to permit BHCs "to acquire or retain ownership in companies whose activities are 'so closely related to banking or managing or controlling banks as to be a proper incident thereto' "[1]. The Fed's decision was not related to the separation between commercial and investment banking as laid out in Section 20 of the Glass-Steagall Act. Instead, it focused on the definition of which services were 'closely related' to banking. The Federal Reserve Board believed that the services of an investment adviser to an investment company were permissible for a Bank Holding Company. The Board proposed defining the advisory services to both closed-end and open-end investment companies as closely related to banking. By way of background and according to the US Investment Company Act of 1940, an open-end company (more commonly referred to as a 'mutual fund') is continuously engaged in issuing its shares and stands ready to redeem them at any time; by contrast, a closed-end investment company typically does not issue shares after its initial offering except at infrequent intervals, equally, it does not stand ready to redeem the shares (United States Court of Appeals District of Colombia Circuit, 1979).

Arguably, the Fed's move was tactically clever: the amendment sought to avoid the impression of a "zero sum" game and positioned it as enlarging commercial banks' activities without cutting that of investment banks. As in a Venn diagram, the Fed wanted to create areas of overlap between commercial and investment banks' activities.

The Investment Companies Institute vehemently opposed the Fed's rationale and made this clear during the consultative process. The Institute saw the entry of Bank Holding Companies into investment advisory services to investment companies as a competitive threat and a clear violation of the Glass Steagall Act, and specifically referred to the ICI vs. Camp case as a precedent. In response to the vocal opposition from the ICI and the US Department of Justice during the consultative process, the FRB changed parts of its proposed amendment to Regulation Y and issued a detailed interpretive ruling. In the ruling, the Fed struck BHC's investment advice to open-end investment companies off the list of activities defined as "closely related to banking". Nonetheless, the FRB concluded that advice to closed-end companies was permissible

[1] (Supreme Court of the United States, 1981)

and within the provisions of the Glass-Steagall Act. In doing so, it made reference to the recent verdict in ICI vs. Camp and asserted that the US Supreme Court prohibited banks from operating open-end investment companies, but believed that closed-end investment companies were not subject to these prohibitions. In the eyes of the FRB, closed-ended investment companies had a relatively low level of securities activities and “are not primarily or frequently engaged in the issuance, sale and distribution of securities” (United States Court of Appeals District of Colombia Circuit, 1979). Moreover, the Fed also restricted BHC’s ability to extend credit to their closed-end investment companies. The Investment Company Institute analysed this amendment, but only filed a petition to the Board around 18 months later in December 1973: it requested the Fed to annul its amendment of Regulation Y. The Fed promptly denied the request.

The legal route

The ICI started legal proceedings and asked the District Court for an injunction against *as well as* declaratory judgement from the Court that the Fed’s action would be illegal. The District Court concluded that not it, but the Court of Appeals had subject matter jurisdiction and therefore dismissed ICI’s case (U.S. District Court for the District of Columbia, 1975). The ICI thus petitioned the US Court of Appeals, District of Colombia. In 1977, roughly two years later, the Court of Appeals heard the case and agreed with the District Court’s Judgement that it had jurisdiction, but asked the ICI to re-submit its petition given that three years had passed since the Fed’s amendment, and additional relevant information might have become available and ought to be included in the ICI’s submission for the court case (United States Court of Appeals, 1977). Finally, and by this time five years after the Fed’s original amendment, ICI vs. the Federal Reserve Board went ahead before the Court of Appeals in 1978.

It is important to note the pace (or lack thereof) of the workings of the judiciary: no external factors could have influenced or sped up this process. During these five years, the absence of planning reliability for commercial banks (i.e. is it riskier to expand their businesses into disputed investment banking territory, at the risk of losing their investments in case the courts ruled them illegal, or riskier not to invest and potentially lose out on significant revenue opportunities, leaving the field to competitors) as well as the potential threat of new market entries for investment banks which was surely in no party's interest. It reflects in part the court's insulation from industry interests.

The Investment Companies Institute argued - as it did before in ICI vs. Camp - that sections 16 and 21 of the Glass Steagall Act clearly restricted the securities-related activities permissible by Bank Holding Companies, under which the advisory services to closed-end investment companies would fall. Indeed, the ICI won in the first level of jurisdiction, yet not on the merits of its arguments.

The United States Court of Appeals for the District of Columbia *rejected* the ICI's argument with respect to Glass Steagall, stating that "the prohibitions of 16 and 21 of the Act [Glass Steagall] applied only to banks rather than to bank holding companies or their nonbanking subsidiaries" (Supreme Court of the United States, 1981). However, in the same verdict, the Court of Appeals concluded that the Bank Holding Company Act, i.e. the legislation establishing regulation of BHCs, did *not* authorise the regulator - the Federal Reserve - to amend Regulation Y, even though the Act itself did *not* prohibit Bank Holding Companies from engaging in those financial activities outlined in 16 and 21 of the Glass Steagall Act. In other words, the Court of Appeals agreed with the Fed's legal interpretation of the Glass Steagall Act: Bank Holding Companies could enter these new business activities. But the Court ruled that the Federal Reserve did not have the **statutory authority** to amend Regulation Y of the Bank Holding Company Act, as this was the task of legislators and not the Federal Reserve.

The court's decision was a Pyrrhic victory for the appellate as well as the defendant: not only did it fail to give a clear verdict as to the separation of investment from commercial banking, but it also appeared to put curbs on the statutory powers of regulators. Given this stalemate, the Fed asked for a re-hearing, which the Court of Appeals denied. Still, the Board believed that the Court of Appeals ruling reflected that the Fed was right in the substance matter – i.e. the Fed's interpretation was compatible with Glass Steagall – and thus petitioned the US Supreme Court to review the case. The US Supreme Court granted certiorari.

The Supreme Court, yet again

The case came before the Supreme Court in 1980, seven years after the Fed's amendment. The Supreme Court overruled the US Court of Appeals and found that the "amendment to the Federal Reserve Board's Regulation Y determining that the services of an investment adviser to a closed-end investment company *may be a permissible* activity under 4 (c) (8) of the Bank Holding Company Act (12 USCS 1843 (c) (8)), which *authorises* the Board to allow holding companies to acquire or retain ownership in companies whose activities are 'so closely related to banking' or managing or controlling banks as to be a proper incident thereto" (Supreme Court of the United States, 1981).

However, in an unexpected move, the Supreme Court went further. The judges shifted the focus of the legal dispute away from Sections 16 and 21 onto Section 20 of Glass-Steagall. The Court concluded that Congress did in fact *not* intend to prohibit commercial banks and Bank Holding Companies from being engaged in any securities related activities "to the contrary, it is more accurately read as merely completing the job of severing the connection between bank holding companies and affiliates 'principally engaged' in the securities business".[2]

The above ruling was more than a mere technicality: the Court's legal interpretation fundamentally altered the then-established view of the Glass-Steagall Act. By focussing on the legal structure of commercial banks, i.e. the Holding Company, the Supreme Court essentially re-interpreted the Glass Steagall Act, and it can be summarised in layman's terms like this:

the line separating commercial from investment banking is not to be found *between* these two worlds of banking, but *within* commercial banks, namely within the Bank Holding Company and its subsidiaries.

The Supreme Court went on to explain its ground-breaking judgement "the Congress that enacted the Glass-Steagall Act did not take such an *expansive* view of investment banking" and that "investment advisers and closed-ended investment

[2] (Supreme Court of the United States, 1981)

companies are not 'principally engaged' in the issuance or the underwriting of securities within the meaning of the Glass-Steagall Act".[3] By introducing the concept of "principally engaged", the Supreme Court added a further layer of Glass Steagall interpretation. Examining the Supreme Court's ruling, the judges drew *two* separating lines:

First, they defined the Glass Steagall Act in relation to the bank's legal structure, i.e. the commercial bank or the Bank Holding Company. As such, the judges ruled that it was illegal for a bank to enter into investment banking territory under Glass-Steagall, However, under certain circumstances (as set out below), it was legal for Bank Holding Companies to perform investment banking services via a subsidiary. The Judges acknowledged and confirmed that Section 21 of Glass Steagall prohibited the *same* legal entity from being active in securities underwriting, but ruled that Section 20 did not prohibit a bank *affiliate or subsidiary* to be active in investment banking.

In a second qualification and gating item to Glass Steagall, the judges ruled that the Bank Holding Company's affiliate or subsidiary could only be active in investment banking as long as it would not be "principally engaged" in activities such as underwriting. The Supreme Court ruled it legal that a subsidiary of a bank holding company could be non-principally engaged in investment advisory services as long as it was not the banking part of a bank holding company that would offer these services at the same time. In this respect, the US Supreme Court ruled that "investment advisers to closed-end investment companies are not 'principally engaged' in the issuance or the underwriting of securities within the meaning of the Glass-Steagall Act, even if they are so engaged within the meaning of the Glass-Steagall Act sections 16 and 21" (Supreme Court of the United States, 1981). This, then, refers to the Court's second rationale, which is to make the separation of investment banking from commercial banking dependent upon a concept of being principally engaged in activities clearly defined as investment banking. Advising closed-end investment companies was not seen as investment banking overall, but even if it was, it was permissible for Bank Holding Companies as long as their subsidiary was not *principally* engaged in this business.

[3] (Supreme Court of the United States, 1981)

Equally important was the US Supreme Court's rejection of the Court of Appeals' judgement about the Federal Reserve's statutory authority with respect to amending existing financial regulation if permissible according to the law. In a landmark judgement, the US Supreme Court clarified and ultimately expanded the powers of the Federal Reserve. The judges argued that the Federal Reserve can amend Regulation Y, and doing so will not exceed the Fed's statutory authority if

> (1) the Board's determination is consistent with the language and legislative history of the act, (2) such investment adviser services are not prohibited by 16 and 21 of the Glass Steagall Act (12 USCS 24 and 378) which restrict the securities related business of banks, and (3) the amendments avoids the potential hazards involved in any association between a bank affiliate and a closed-end investment company, an interpretive ruling (12 CFR 225, 125) issued by the Board with the amendment expressly prohibiting a bank holding company or its subsidiaries from purchasing or participating in the sale or distribution of securities of any investment company for which it acts as an investment adviser (Supreme Court of the United States, 1981).

In this judgement, six judges, namely, Stevens, Burger, Brennan, White, Marshall and Blackmun, dismissed the ICI's petition whilst three justices abstained.

4.6 AN IPE ANALYSIS OF *Board of Governors of Federal Reserve System vs. Investment Company Institute*

The role of the judiciary is a lesser-known, if not completely unknown research topic in the IPE of finance. In the spirit of Montesquieu's monumental work *The Spirit of the Laws* and the idea of the separation of powers – between judicative, legislative and executive – the US judiciary is independent from the US government and Congress (Montesquieu, Cohler, Miller, & Stone, 1989). Whilst the US President has the right to nominate Supreme Court judges, and the US Senate has to approve the President's nominees (or veto them), the Supreme Court and its judges typically sit above the daily business of politics. The Supreme Court is reactive: it neither interferes with the legislative nor executive unless a decision is brought up via the judicial court system that requires an interpretation or ruling from the highest court within the context of the US constitution and laws.

One could argue that the US Supreme Court is politicised by virtue of the presidential nominations. There is clear tension between the US President's power to nominate candidates that are seen as 'close' to or philosophically in 'spirit' with his/her political party ideology, i.e. either the Republicans or Democrats, and ensuring that the US Supreme Court does not get too politicised and really stands above the horse trading of Washington politics. Upholding both aspects requires a fine balance, but broadly speaking, the formal institutional setup of the US Supreme Court and even the approval process of judges has several features that act as barriers against politicising the highest court in the US:

Firstly, Supreme Court judges have tenure for life, and can only be removed with a Senate majority vote. An impeachment of a Supreme Court Judge has never happened in the history of the US. Many potential candidates will have reached a certain age by virtue of having established a venerable track record in jurisprudence and this may, of course, shorten their potential tenure by virtue of age. However, looking at judges' actual length of Supreme Court service, it is clear that many of them serve for twenty, often thirty years. Long tenures not only give a sense of continuity, but also lift judges out of the relatively short Presidential and Congressional cycles, making it challenging for any one ruling party to nominate a majority of judges, as the setup of US Supreme Court judges varies widely by age.

Secondly, the nomination, approval and impeachment process of judges is rigorous, and nominees typically receive a greater proportion of Senators' votes than any party alignment would otherwise suggest, or they win the approval from all Senators. Receiving more than a simple Senate majority is in itself a reflection that this process is both more removed from the day-to-day business of politics and that the nominees are of appropriate standing to both US parties. US Presidents' digression in nominating candidates is thus checked by the US Senate, whose Committee on the Judiciary conducts all nomination hearings. The hearings are rigorous, and committee members expect only candidates of the highest calibre to be nominated. This fact becomes obvious when looking at cases where the President has had to withdraw a nomination. President George W. Bush Junior nominated Ms. Harriet Miers as Supreme Court Judge in 2005. President Bush was widely and publicly criticised from all sides of the political spectrum for nominating Ms. Miers, who was considered lacking in experience and intellectual wit. In fact, the top-ranking members of the Committee were so irritated by the lack of Miers's knowledge that they publicly "complained about the written responses they received from Supreme Court nominee Harriet Miers this week, and warned her to expect tough questions from Republicans and Democrats alike when her confirmation hearing begins Nov. 7" (Babington & Fletcher, 2005). Even before the hearing started, President Bush bowed to the pressure and withdrew his nomination of Miers. Whilst Bush's move could be seen as exceptional, it was by no means the first such occasion: US Senators refused the approval of candidates who they believed unworthy of being a Supreme Court Judge.[4]

Besides institutional safeguards to securing the political independence of the US Supreme Court, there are also several softer factors playing a significant role. Not infrequently, so-called 'conservative', 'moderate' or 'liberal' judges turn out to be either 'swing voters' (i.e. they do not follow a clear conservative or liberal line of judicial philosophy) or actually vote for the 'other side'. Again, there are several reasons for this. Supreme Court judges are not party political animals, but are legal professionals who have and follow a clear legal philosophy. Being 'conservative' or 'liberal' as a Supreme Court judge refers to the judges' judicial philosophy, and can never be appropriately matched to the ideologies of US political parties: i.e. they do not pass judgement on US republican or democrat politics, but whether or not decisions taken by judges below them, the executive or the legislative, are within the spirit of the US constitution and laws.

Depending on judges' legal philosophy, they may *interpret* the US constitution and laws differently. Nevertheless, it is interesting that several so-called 'conservative' judges have voted against legalising abortion, not on the grounds of

[4] As of May 2015, a total of twelve nominees were fully considered and rejected,

morality or ethics, but simply on the grounds that a decision such as the legality of abortion is not an issue that ought to be defined via the US constitution, but decided upon by Congress rather than the Courts. As one former US Supreme Court judge put it during one of the author's interviews

> Ruth[5] and I would fight about the interpretation and meaning of the constitution all the time. She is an unbelievably fast and clever thinker and we both knew that our arguments were about intellectual differences, about the letter of the law. Never was it about party politics. Never. Only out of court at the opera or during meals or a glass of wine would we discuss politics. Never in court (SA, 2015).

Moreover, the Supreme Court's decisions are made public, and one can thus easily examine how individual judges ruled in each case and whether a consistent voting pattern emerges. With respect to ICI vs. Camp (401) and ICI vs. FRB (450), the table below summarises the judges' decisions. The analysis shows that several judges have changed their votes on the issue of the Glass Steagall Act in favour of the Fed as a regulator and against a more narrow definition as laid out by the ICI. It is therefore not possible to establish a pattern according to liberal vs. conservative lines in these two key legal cases.

			ICI vs. Camp - Apr 1971				Fed vs. ICI - Feb 1981			
	Service	Nominated by	In Favour	Dimissed	Abstained	Dissented	In Favour	Dimissed	Abstained	Dissented
Hugo Black	Aug 1937 - Sep 1971	Roosevelt (D)	x				retired			
John Harlan	Mar 1955 - Sep 1971	Eisenhower (D)				x	retired			
William Douglas	Apr 1939 - Nov 1975	Roosevelt (D)	x				retired			
Potter Stewart	Oct 1958 - July 1981	Eisenhower (D)	x						x	
Warren Burger	June 1969 - Sep 1986	Nixon (R)			x		x			
William Rehnquist	Jan 1972 - Sep 1986	Nixon (R)							x	
Lewis Powell	Jan 1972 - June 1987	Reagan (R)							x	
William Brennan	Oct 1956 - July 1990	Eisenhower (D)	x				x			
Thurgood Marshall	Oct 1967 - Oct 1991	Johnson (D)	x				x			
Byron White	Apr 1962 - June 1993	Kennedy (D)	x				x			
Harry Blackmun	June 1970 - Aug 1994	Nixon (R)				x	x			
John Stevens	Dec 1975 - June 2010	Ford (D)					x			

Source: US Supreme Court

When looking at judicial decisions, especially at the level of the Supreme Court, it is challenging for IPE researchers to apply their standard theoretical frameworks to analyse regulatory outcomes brought about by courts. Firstly, from a

[5] US Supreme Court judge Ruth Bader Ginsburg

theoretical standpoint, interest group based theories cannot be applied. The judiciary is removed from the day-to-day activities of politics and business; it is, by default and law, unresponsive to any lobbying. Financial contributions to judges are simply illegal and there is no revolving door to Wall Street. In fact, none of the Supreme Court judges entered private practice post retirement. Their life tenure makes any private practice unlikely and it removes the possibility of any post public service pay-offs. Secondly, theories based on the idea that lobbying can influence and generate outcomes hold no teeth with the judiciary: if two powerful industries sue each other, we no longer face a situation of Goliath, i.e. big corporates, vs. David, i.e. consumers/citizens. In other words, not only can judges not be influenced via financial contributions or information sharing, but it is also not at all clear which financial industry is more powerful in the investment banking vs. commercial banking stand-off. Thirdly, the Supreme Court is an institution that ensures that actors play according to the “rules of the game”, but similar to the legislative, it can also alter the rules of the game. It is, thus, a hybrid.

Looking at the decision Fed vs. Investment Company Institute through the lens of the thesis’s hypotheses, we can test the hypotheses’ applicability. ‘The Revolving Door’ hypothesis has limited application, as Supreme Court judges have tenure for life and did not enter investment banking after their service, nor did they join an investment bank or law firm specialising in Wall Street financial regulation after their tenure. In short, without knowing whether a revolving door has any impact on regulatory and or judiciary decision-making, the pathway of lobbying via revolving door between the US financial industry and the US Supreme Court does not exist. The involvement of the judiciary essentially contradicts the predominant scholarship in IPE about the revolving door.

Looking at the thesis’s interest group hypotheses – owning privileged information which they provide to regulators and legislators – is applicable here, but not in the way that one would think: there is no behind-closed-doors information exchange or untoward tit-for-tat between the industry and government. On the contrary, the industry has to make its case, in public in front of the courts, as to why they are for or against certain regulatory decisions and thus changes brought about by the regulators. It is therefore in this very public setting and via the judicial process that they provide the courts with information by virtue of being a defendant or an appellate. Moreover, let us take a step back and think about the defendant and appellate again: the US Fed vs. the ICI; clearly the investment banking industry lost this case.

Applying the statutory authority hypothesis,namely that regulators can change the rules of the game irrespective of their mandate/statutory authority: this is broadly true here, even though the Fed was convinced that it was acting within its authority. In the words of one of the Fed's counsels involved in this case at the time, "we did a through legal assessment before we issued our proposed amendment to Regulation Y – we were certain that the ICI would want to take us to court, but we were equally certain that they would have no leg to stand on" (BS, 2010).

The thesis's judiciary hypothesis – significant regulatory change brought about by the courts without legislative change – is proven correct here. The US Supreme Court has reviewed Regulation Y and essentially opened the doors for Bank Holding Companies to engage, albeit not principally, in investment advisory services. In fact, the thesis shows that this decision by the Supreme Court was ultimately to set in motion a lengthy process of both regulatory change and judiciary decisions that would bring about the repeal of Glass Steagall. Furthermore, it is absolutely key to highlight that the Fed neither proposed nor asked for such an re-interpretation of the Glass Steagall Act; in fact "we were absolutely surprised about the Supreme Court's ruling and its interpretations, which we would never have put on the agenda; we were glad that we won the case, but also faced a very different Glass Steagall environment from then onwards" (ibid).

The role of ideas hypothesis may be applicable in this case, but it cannot be verified, as some judges changed their judicial philosophy from moderate to liberal and vice versa during their career. However, as pointed out at the beginning, even the Senate hearings during the approval process of nominees question candidates' legal philosophies, especially with respect to controversial matters, such as abortion. But it is important to keep in mind, as one former Supreme Court judge put it during the interview: "Supreme Court judges are not politicians, we are not bankers, we are not lobbyists. We are simply concerned with the spirit of the law and its most appropriate interpretation. The Constitution is the Constitution" (SA, 2015).

Hans Trees
SGIA, Durham University

Chapter 5

THE REPEAL OF GLASS STEAGALL: THE VOLKER YEARS

5.1 INTRODUCTION

The first case study examined the origins of the Gramm Leach Bliley Act and ultimately found them in a court case between the Office of the Comptroller of the Currency (OCC) and the Investment Companies Institute (ICI) (Supreme Court of the United States, 1971). It was one of the first judicial cases that dealt with the separation of investment from commercial banking as set out by the Glass Steagall Act (Federal Reserve Bank of New York, 1933). The OCC failed to provide adequate guidance as the first case study showed: the court case between the ICI and the Federal Reserve with respect to the Fed's amendments to Regulation Y (United States Court of Appeals District of Colombia Circuit, 1979) ended with the US Supreme Court providing a legal interpretation of the Glass Steagall Act (Federal Reserve Bank of New York, 1933) that would radically redefine commonly held beliefs about the separation between investment banking and commercial banking on both sides of the industry fence. The Court ruled that Section 20 of Glass Steagall defined the line separating investment from commercial banking as being *within* the Bank Holding Company, i.e. between the Holding and its subsidiaries as well as affiliates. For as long as these subsidiaries and affiliates were not "principally engaged" in the securities business, the Bank Holding Company was not in breach of Glass Steagall. At the same time, the US Supreme Court clarified that the Federal Reserve had the statutory authority to amend Regulation Y, and that its amendment "was consistent with the language and legislative history of the act".

The Court's ruling carries important learning and consequences for the scholarship in the IPE of finance: it introduces a hitherto neglected actor on to the stage of regulatory decision-making: the courts. The ICI vs. Fed case did not simply clarify whether or not the Fed exceeded its statutory authority; it actually brought about significant regulatory change without legislative change and without the regulator, the Fed, seeking this specific legal interpretation of Glass Steagall. The US investment banking [body? Industry? Branch?] clearly lost this case: they had to accept the re-entry of Bank Holding Companies into their turf without anything in return.

With the Supreme Court having set the stage for a re-thinking of Glass Steagall, the second case study examines the Fed's next movements under the Chairmanship of Paul Volcker. The Supreme Court ruling made Bank Holding Companies' re-entry into investment banking dependent upon the concept of their subsidiaries and affiliates not being 'principally engaged' in the securities business as per Section 20 of Glass Steagall. However, the Court did not provide a comprehensive list of activities, percentage limits or otherwise measureable performance indicators that would allow Bank Holding Companies to understand and identify when their operations would be principally engaged and when not. In other words, the court did not provide a definition as to what 'principally engaged' meant in practice.

As this case study shows, the Fed received various requests from Bank Holding Companies who were encouraged by the US Supreme Court's ruling and sought to re-enter the investment banking business. The Fed was put in the difficult position of having to interpret the US Supreme Court ruling as well as the original Glass Steagall Act by way of finding a compromise between the two. It was thus in the unique position of having to interpret Glass Steagall from a legal perspective in order to then translate its interpretation into regulatory decision-making. It did so at various points in the Volcker years; each time it was taken to court, it won. However, whilst the Courts provided a specific interpretation of Glass Steagall, it was really the Fed as a regulator who established a body of 'case law' or precedents that ultimately confirmed the Fed's amendments in front of the court as they were challenged by the investment banks. In sum, it was regulatory change by statutory authority without legislative change.

5.2 THE SIA VS. THE FED: THE CHARLES SCHWAB CASE

Introduction

Lobby groups, such as the American Bankers Association or the Investment Company Institute, can be in a dialogue with US regulators to exchange information or express their opinions, yet they cannot and do not influence regulators by way of financial contributions. The Chicago School of Regulation is thus not applicable in this case, as Congress did not intervene or change the laws governing BHCs. Even more striking is the fact that the Fed's amendment of Regulation Y was then contested in the courts. The judiciary is both independent from the legislative and executive powers of the state, acts as a check towards them and is open to anyone (anyone has the right to go to court). The last point is important as it highlights that litigation is not an exclusive route that is only available to a select group of people or institutions. On the contrary, anyone could have contested the Fed's decision to amend the BHC regulation.

The courts themselves are above any external lobby influence. It is strictly illegal to influence the judiciary by way of lobbying in financial or informational terms. The courts rule whether amendments made by the regulators by-pass the legislative process. As such, the entire process by which lobby groups influence legislation through campaign contributions is hollowed out. The mechanism by which a regulator can thus propose regulatory change and have the courts either confirm or dismiss it is of vital importance. Moreover, the Supreme Courts decision is so significant as it established a basis upon which the Federal Reserve could judge whether certain financial activities, if carried out by BHCs, were in breach of the Glass Steagall Act. The judge's reference to Section 20 and their legal clarification of its meaning are especially noteworthy. This case and the Court's clarification of Section 20 became *the* point of reference for the Federal Reserve's decision-making as regards the separation of commercial banking from investment banking.

Roughly half a year after the Supreme Court's Decision in Fed vs. ICI, Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System, made several remarks during his speech at the Annual Convention of the American Bankers

Association (ABA) in San Francisco in October 1981 that picked up this case. Chairman Volcker remarked

> the line between banking and other financial services has become blurred. It needs both redefinition of the appropriate border, and clear recognition that some substantial overlapping in the provision of services by different types of institutions – bank and non-bank – can *enhance* [emphasis added by author] competition (Volcker, 1981, p. 7).

Paul Volcker is often, and wrongly, stylised as an anti-investment banking, pro Glass Steagall regulator, especially with regard to the relatively recent 'Volcker Rule'[1] which the FT's Lex column labelled "one of the silliest bits of the Dodd-Frank Act" (Lex Column, 2011). It is interesting that in his speech to the ABA in 1981, Volcker did not urge Congress to pass legislation and revoke the Glass Steagall Act. To the contrary, he simply argued that a 'redefinition' of the 'appropriate borders' between banking and investment banking was needed without mentioning who should be in charge of that redefinition, and explicitly making his point that he

> will not attempt to suggest here precisely where the lines should be drawn, but only the scope of the debate. For instance, the question of commercial banks selling commercial paper or underwriting of municipal revenue bonds, which the Federal Reserve Board has long supported, seems to me quite different from underwriting corporate stocks, where questions of ownership, potential conflicts of interest, and risk are much greater (Volcker, 1981).

Moreover, Volcker highlighted that the overlap resulting from blurred borders could increase competition which would be positive for clients. According to Volcker, "the field for possible expansion [for BHCs] is broad indeed, including, for example, some forms of insurance, management consulting, travel services, at least some securities activities, money […], and data processing and transmission" (Volcker, 1981, p. 8).

[1] To give a brief explanation of the rule: it essentially aims at preventing banks from engaging in risky financial activities, predominantly propriety trading.

Volcker's statement reflects a very clear sense of direction for the Federal Reserve and its regulation of Bank Holding Companies: the Fed was comfortable with BHCs becoming somewhat active in a broad spectrum of financial services, many of which had not been described as being their "core". He also supported the idea that BHCs should be able to sell commercial paper and underwrite municipal bonds, even though he was cautious not to be too descriptive as to where the spectrum of possibilities for Bank Holding Companies starts and where it ends (Volcker, 1981).

Only a few months after Mr. Volker's speech, the Federal Reserve took another important decision with regard to Glass Steagall and banking-related activities. In March 1982, the Bank of America Corporation, America's second largest BHC by assets, filed an application for permission to acquire Charles Schwab, the parent company of America's then largest discount brokerage firm. The Federal Reserve issued the application in its register and requested public comments (Federal Reserve, 1983). Contrary to the otherwise existing, extensive turf wars between US financial regulators (for example (Suarez & Kolodny, 2011), the Securities and Exchange Commission (SEC) commented in favour of the Fed's decision, as did the Department of Justice and the Comptroller of the Currency (Federal Reserve, 1983). This is remarkable, as the Federal Reserve indirectly gained more regulatory responsibility by way of allowing one of its regulated entities to gain more operational freedom. Despite the fact that Charles Schwab was SEC supervised, Bank of America was supervised on a consolidated basis by the Fed, which of course gave it unique insights into the ins and outs of the retail investment banking arm, i.e. Charles Schwab.

The main opposition came from the Securities Industry Association (SIA), which represented the interest of the investment banking industry at large. Investment Banks were extremely alarmed that Bank Holding Companies were not only to come back on to their turf, but to acquire outright the country's largest retail brokers for securities (DJ, 2010). The SIA asked for a formal hearing with the Fed. The Federal Reserve granted the SIA's request and formal public hearings took place in front of an administrative law judge who was asked to consider the application. The hearings in which the SIA, the Fed as well as Justice Department participated took six days. The judge in charge of this hearing issued his ruling thereafter: he found Bank of America's acquisition proposal to be consistent with both the Bank Holding Company Act and Glass Steagall, and recommended that Bank of America's acquisition be approved.

After the formal hearing, the Fed ruled that "Schwab's brokerage services are operationally and functionally very similar to the types of brokerage services that are generally provided by banks and that banking organizations are particularly well equipped to provide such services" (Federal Reserve, 1983, p. 107). The Board believed that the public benefits from increased competition, convenience and efficiency outweighed adverse effects. At the time, Charles Schwab was not just any discount brokerage firm, but the largest in the USA. The Board, however, assessed that Schwab was not "engaged principally" in any activities prohibited under Section 20 of Glass Steagall, and that "the business of purchasing or selling securities upon the unsolicited order of, and as agent for, a particular customer does not constitute the "public sale" of securities for purposes of section 20" (Federal Reserve, 1983, p. 114). In its interpretation, the Federal Reserve Board then specifically referred to the *Board of Governors of the Federal Reserve vs. Investment Company Institute* case where

> "the Supreme Court has made clear, section 20 determines the permissible securities activities of an affiliate of a bank and the fact that a bank might be precluded from engaging in a particular securities activity does not necessarily mean that a bank holding company is precluded from performing such services" (Federal Reserve, 1983, p. 115).

As was the case in allowing BHCs to enter the business of advisory services to closed-end investment companies, it was the regulator's decision and not the legislator's to give BHCs the go-ahead to acquire discount brokerages. However, the Fed operated within its statutory remit and could fall back on the Supreme Court Ruling which had made this acquisition possible in the first place. The lobby groups were able to provide their comments during the public hearing period, but ultimately, the regulators could not be lobbied financially, and the Federal Reserve followed the body of case law applicable to regulating Bank Holding Companies closely. As the then General Counsel of the Securities and Exchange Commission recalls, "the lobby groups, especially the SIA and ICI were unbelievably active, but only effective at the margin" (GE, 2010). As in the earlier case, the lobby group whose business was adversely affected started legal proceedings alleging that the Fed's decision was violating the Glass Steagall and the Bank Holding Company Act.

The United States Court of Appeals for the Second Circuit decided in July 1983 that the SIA "petition for review [is] denied, because no statutory authority prohibited a bank holding company from engaging in retail brokerage, and respondent [Fed] acted within respondent's discretion in approving intervener's application"[2]. The SIA appealed, which was granted, but the Supreme Court affirmed the lower court's decision in June 1984. In its decision-making, the Supreme Court argued

> that it was reasonable for the Board to determine that the acquisition was not prohibited by 20 of the Glass Steagall Act […] and that the Board has authority under Paragraph 4 (c) 8 of the BHC Act to authorize a bank holding company to acquire a nonbanking affiliate engaged principally in retail securities brokerage (Supreme Court of the United States, 1984).

The Supreme Court of the United States made thus another significant ruling and, as before, it was the process of litigation and the decision of the courts that ultimately confirmed the Federal Reserve's regulatory change without there being correspondent legislative change. The investment banking industry lost against the Fed and the commercial banking industry once again.

As was argued earlier, the judiciary is independent, and any interest group pressure on it forbidden. The courts thus take a central role in financial regulation. Let us assume for a moment that the Federal Reserve would have decided against Bank of America's acquisition of Charles Schwab. In this hypothetical scenario, the SIA would have been content with the outcome, whilst Bank of America or any banking lobby organisation might have started legal proceedings and sought the path of

[2] (United States Court of Appeals for the Second Circuit, 1983)

litigation. Either way, any amendment made by the Federal Reserve, or any other regulator for that matter, is open to litigation by essentially any party. The judiciary is open to anyone and will hear any case if there is substantiated evidence for a breach of law. Applying the thesis's judiciary as regulator hypothesis, this case reflects that the judiciary is the only power in the state besides the legislative whose decisions can verify, nullify and alter financial regulation. And yet, it is the only power within the state that is above and beyond any lobby group influence such that any interest group-based accounts of explaining regulatory change do not apply for the judiciary. The justification for this is simple: if interest groups could lobby and influence the judiciary, if the judiciary was not fully independent, then we are not talking about a modern advanced state with a clear separation of powers. Rather, we would be analysing a dictatorship or authoritarian state.

Reasons for the Fed's sanctioning of the Charles Schwab acquisition

As can be seen from the Fed's comments and Chairman Volcker's statements, the Fed believed that the acquisition would result in more competition, which would increase the financial sector's overall efficiency and convenience for customers. It was one of the first such statements in which the Fed argued that the externalities of freer, competitive markets would outweigh the adverse effects. There was, however, a second motive behind the Fed's decision-making: Bank Holding Companies had suffered from a decline in their earnings power for a set of complex reasons (such as a cap on interest payables to customers, entry of thrifts into checking accounts, oil crisis, inflation etc.) "which concerned the Fed as it could affect the stability of the financial system whilst at the same time margins in many areas of investment banking, such as retail brokerage, were very attractive"(GRo, 2010).

5.3 THE COMMERCIAL PAPER RULING

The Federal Reserve's decisions to amend Regulation Y caused the unintended consequence that the Supreme Courts clarified the meaning of Section 20 of Glass Steagall. It was this clarification that allowed the Federal Reserve to start "testing" which financial activities the Courts would regard as 'principally engaged' and which ones they did not. The Board then used this definition when it reviewed Bank of America's request to purchase Charles Schwab and granted BHCs permission to acquire discount brokers. As set out before, the courts not only provided the regulator with clear guidance as to how to interpret the laws and amend them as appropriate, they also sided with the Fed, and thus judged that the regulatory change as made by the Fed was legal.

Congress was not complacent about the US Supreme Court's ruling and its consequences. It did consider a bill called the 'Financial Services Competitive Equity Act' in 1984 that would have changed certain aspects of the Securities Exchange and the Banking Act of 1934 in order to overhaul Glass Steagall and allow greater freedom of operational movement between investment and commercial banking (US Senate, 1984). The Bill was introduced by Senator Edwin Garn from Utah and proposed two major amendments: first, it proposed to amend the Banking Act of 1933 "to allow a member bank to be affiliated with a depository institution securities affiliate" and have officers, directors and employees from both being able to sit and serve on both the banking and securities affiliate at the same time; second, to change the Securities Act of 1933 "to exempt from the registration requirements of such Act the issuance of a holding company's shares in connection with a reorganization in which the holding company becomes the parent of a bank or thrift institution" (ibid)**.** The bill passed the Senate, however it never made it through the House.

Absent legislative change, the Supreme Court decisions regarding Section 20 and Volcker's speeches encouraged Bank Holding Companies to seek a dialogue with the Federal Reserve as to which other activities the Fed regarded as 'permissible'. In December 1984, Citicorp applied to the Federal Reserve Bank of New York for permission to enter corporate debt capital markets, especially commercial paper. In its application, Citicorp argued that not the Holding Company, but an affiliate – Citicorp Securities – would carry out the securities activities. The Wall Street Journal reported that "the underwriting authority that Citicorp seeks would have been authorized by legislation that failed to win passage in Congress this year" confirming the earlier argument that the Fed could indeed alter financial regulation without there being legislative change if the courts confirmed the Fed's amendments (The Wall Street Journal, 1984). The Wall Street Journal went on to say that "Citicorp was encouraged to act by a federal appeals court decision – upheld this year by the U.S. Supreme Court – that allowed Bank of America's acquisition of Schwab" (The Wall Street Journal, 1984). However only two months later, the Fed decided that Citicorp's application would violate the Glass Steagall, in response to which Citi withdrew its application with the intent to file a new, modified one.

The author interviewed a New York based senior partner specialising in banking regulation at a top international law firm. Widely regarded as one of the foremost experts in US and international banking regulation, he worked at the Federal Reserve as counsel in the 1980s and was privy to all these discussions and decisions. He recalls that "there was so much pressure from the big banks that they just had to be able to do some amount of underwriting in order to compete with the investment banks and keep their customers - this went on for years."[3] (BS, 2010). He highlights that "one day around the time of the Citi application, JPMorgan gave the Fed a paper where historic statistics showed that the most risky and dangerous financial business you could be in was commercial lending because you cannot sell it off" (ibid). This paper showed that securities could be sold off and benefited from the public disclosure whilst commercial loans – set aside the commercial paper market – "were illiquid, in a lot of cases fairly opaque and concentrated - so in fact, it is safer to underwrite and deal" (ibid). According to various accounts from interviews, the New York Fed was supportive of JPMorgan's arguments, but the Washington Fed felt "that underwriting and dealing was just a very dangerous business" (BJ, 2010).

Around the same time as Citi's application, the Bank Holding Company Bankers Trust asked for permission to place commercial paper, but so that "Bankers Trust's placement of commercial paper as described in this Statement does not constitute the "selling", "underwriting" or "distributing" of commercial paper securities for the purposes of the Act [Glass Steagall]" (Federal Reserve, 1985, p. 629). During the consultation period, the Fed received a range of comments, many in favour of Bankers Trust, but three opposing the application: The SIA, the ICI and Merrill Lynch Money Markets. All three contended that the activities Bankers Trust sought to undertake were in violation of the Glass Steagall Act, as these activities

[3] Interview with a senior partner specialising in banking regulation. He is based in the New York office of a premier international law firm and published widely in his field. As a result of his deal record and expertise, he is seen as one of the world's top experts in banking regulation.

were not closely related to banking, and would result in conflicts of interests and bring with them substantial risks. Furthermore, all three argued that the meaning of "principally engaged" had to be literally applied, as otherwise it could vitiate the central purpose of the Glass Steagall Act by allowing member banks to re-establish "security affiliates" that could rival the largest investment banking firms" (ibid).

The Fed granted permission this time, as it believed that this activity passed the test of being closely related to banking. The guidelines to this test were established in a different court decision, known as the National Courier decision in 1975. An activity 'closely related to banking' had to pass three criteria: firstly, banks provided the proposed activity before, secondly, they generally provide services that are functionally or operationally similar and thus equip them well to provide the proposed activity and, finally, banks provide services that are so "integrally related to the proposed activity" that they in fact necessitate their provision in a specialised form (Federal Reserve, 1987a).

The Securities Industry Association was furious and opened litigation against this decision. A long and protracted legal battle followed, during which both sides scored victories and injunctions were issued. During this litigation process, Chairman Volcker testified before the House Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations in 1985 and said that "as things now stand, the pressures for change are reflected in, and potentially distorted by, exploitation of perceived loopholes, reinterpretation of existing laws by regulators and the courts" (Paul Volcker, 1985). In an apparent change of heart, he argued that "these questions about banking law and Congressional intent need urgently to be resolved by fresh expressions of substantive law […] the problem becomes steadily more acute with the passage of time" (ibid).

He saw bank holding companies, thrifts, insurance companies and investment banks expanding onto each other's territories "whenever and wherever they can find room through new interpretations of Federal law or new state law" (ibid). A few years back, Volcker talked about potential efficiency and convenience gains thanks to greater competition; in 1985 he warned that "long established policies set by the Congress are breaking down" which causes "confusion" and the loss of shareholders' equity (ibid). What is slightly odd about Volcker's statement is the depiction of regulators, the Fed included, as passive agencies that have no choice but to grant ever greater permissions to Bank Holding Company requests. This appears contrary to the US Supreme Court Rulings which made it explicit that the Fed had statutory authority to decide when something is compatible with the intention of the law. If, as Volcker emphasised, "equity is lost" and "confusion abounds", the Fed would not need to grant BHCs permission to expand into investment banking activities.

Volcker's statement, made fourteen years before Congress's official repeal of Glass Steagall, highlights the problems associated with the process of regulatory change without legislative change. He was very candid and direct in identifying the factors behind this change as well as the culprits. Interestingly, this very emphatic statement has not been picked up in IPE sources so far.

Ultimately, the United States Court of Appeals for the District of Columbia Circuit decided on 23 December 1986 that "the placement of commercial paper issued by third parties did not cross the line into investment banking; the literal requirements of the Glass Steagall Act limiting such activities were met"[4]. Only one day later, on Christmas Eve, the Board of the Federal Reserve granted Bankers Trust' permission "to act as agent and adviser to issuers of commercial paper in connection with the placement of such commercial paper with institutional purchasers" (Federal Reserve, 1987a, p. 138). Bankers Trust conducted these activities through its wholly owned subsidiary BT Commercial Corporation, itself a wholly owned subsidiary of BT Leasing Services Inc.

The Fed imposed a long list of conditions for its approval. For examples, as a revenue and market test restriction, the

> Company would not be engaged in a general securities or investment banking business and where its gross revenue from commercial paper activities in any one year would constitute less than 5 percent of its total gross revenue and the volume of commercial paper outstanding at any one time placed by Company

[4] (States, 1986)

> represents less than 5 percent of the average amount of dealer-placed commercial paper outstanding during the previous four calendar quarters (ibid).

At the same time, the Board made a clear distinction between granting permission to the Bankers Trust and reviewing separate applications from Citigroup, J.P. Morgan & Co. because these "applications are substantially different from the Applicant's [Bankers Trust]" since they involve "complex factual and legal issues to underwrite commercial paper, mortgage-backed securities, municipal revenue bonds and consumer-related receivables in an affiliate that also underwrites U.S. government securities" (ibid, p. 140).

Chairman Volcker added a personal statement with the Board's approval of Banker Trust's application. It says

> today's decision, applying the Glass Steagall Act, makes as much good sense as is possible to draw from applying a law, adopted a half-century ago, to a banking marketplace that technology and other competitive forces have altered in a manner and to an extent never envisioned by the enacting Congress (ibid, p. 154).

He justified the Board's decision-making by saying, "in the light of the intent of the Act, which has long been considered, in short hand, to require the divorce of investment and commercial banking, the Board's conclusion that the term "engaged principally" includes any substantial activity, even if that function is less than 50% of the total, seems to me to be correct" (ibid). He emphasised that "the limited decision taken by the Board today only emphasises the fact that authority for underwriting of securities by banking organisations urgently needs to be legislatively reviewed and updated" (ibid). He was concerned that

> no useful public policy goal is served by the incentive created by the Glass Steagall Act, as we must interpret it, to shift assets (such as commercial loans) out of a bank and into nonbank affiliates of a holding company so that the affiliates are large enough to permit

> significant amounts of underwriting without being "principally" in that activity (ibid).

Volcker's position on the Glass Steagall Act and the Fed's position of granting investment banks permission to re-enter investment banking activities clearly evolved over time. Back in 1981, Volcker was more positive about Bank Holding Company's entry intro investment banking; by 1986 his mood turned negative and he wanted Congress to act.

Six months later, the SIA finally lost its law-suit when the Supreme Court denied certiorari in June 1987.

Towards the middle of the 1980s, the Federal Reserve amended various aspects of financial regulation. The Board did so after public comment periods and often receiving independent legal advice. The Supreme Court of the United States mostly judged in favour of the Fed's amendments, thereby slowly building up a corpus of case law, and within it important regulatory clarifications and (re-) interpretations that allowed the Fed to grant Bank Holding Companies permission to re-enter more and more financial activities that were previously thought to be impermissible. As argued throughout these paragraphs, the motives behind the Fed's decision-making need to be explained further, as the industry brought most cases to the Fed for its attention. It is not clear whether Chairman Volcker's statement of frustration with the current regulatory framework and his repeated pleas for Congress to pass a new law is representative of the Fed as a whole. Indeed, as the court decision in OCC vs. ICI in the 1960s demonstrated, regulators had to provide a detailed commentary outlining their reasons as to why a permission is compatible with the legislative intent of a law. In the Bankers Trust case, the Fed – if it felt as uneasy as its Chairman – could have denied permission whilst providing detailed reasoning so as to stand up in front of the courts. However, the Fed did not. There thus appears to be some disconnect building up between Chairman Volcker's remarks of the Fed having to stand by passively as events unfold and the Fed's statutory authority in defining or interpreting as to where "principally engaged" starts and ends.

Analysing the data from the court decisions, the newspaper articles and the speeches, it is clear that the Board of the Federal Reserve did not want to do away with the separation of investment banking from commercial banking. Rather, the Board took a view, time and again, that certain financial activities, such as distributing commercial paper or acquiring a discount brokerage, were closely related to banking and as such not covered by Glass Steagall. Chairman Volcker's speeches emphasise these points. He was clearly comfortable with BHCs entering these activities, as much as he was uncomfortable with crossing lines into the underwriting of securities or other services clearly linked with investment banking. At the same time, Chairman Volcker's openly expressed his frustration about Congress's inability to pass new legislation. According to the former Fed counsel, "Volcker had very 19th century views on commercial banking, was the one who said 'stand back, let this market develop and see how it plans out' [referring to the commercial banks entering investment banking activities such as commercial paper and discount brokerage] and I think that either explicitly or implicitly they kind of made a bargain with the industry – instead of having fairly rigid rules and the examiners coming in counting currency and this kind of thing, they were going to stand back, let them develop, let them compete, get the new products. The trade-off was more capital. There would be enough capital, because there would be enough capital to cover up the mistakes. So the result was that the industry did get a much freer hand than they used to have and they innovated and did these new things" (SB). It is interesting that Volcker's ideational mind-set about financial regulation was clearly not a necessary explanatory variable to explain the regulatory outcomes at the time. He was neither fully for nor against the separation of investment banking from commercial banking - this can be easily proven with his voting patters in the Board and his speeches. In fact, he was simply for greater legislative clarity: in other words, a repeal or reform of Glass Steagall.

The role of interest groups and their supply of information as in the case of the JP Morgan paper appear to have had some effect on these regulatory decisions in that it strengthened the voice of the NY Fed within the Fed System. In addition, lobby groups were allowed to provide public comments on the Fed's proposed amendments and they were likewise able to start legal proceedings. Neither of these two aspects are exclusive pathways though. On the contrary, they are open to anyone. As such, interest group hypotheses can be tested, but the provision of information had no meaningful effect as an explanatory variable in this instance.

The judiciary has clearly been the necessary explanatory variable in all these outcomes. The Supreme Court's decisions ultimately either reversed or – as was largely the case – confirmed the Fed's decisions. The role of the Fed and its statutory authority was less clear – it clearly enjoyed the statutory authority, but it seems that there was no dominant ideational consensus within the Fed, as Volcker's words of warning reflect (which stand in contradiction to the Fed granting permission to Bankers Trust).

By the beginning of 1987, the lines between commercial and investment banking had become less clear, yet were still intact. However, as a result of the Supreme Court's decision with regard to Glass Steagall and Section 20, BHCs were hopeful that the lines could become even more blurred: not as a result of legislative change, but as a result of further Fed amendments and court orders. It is in 1987 when the ultimate undermining of Glass Steagall began. A second bill to overhaul Glass Steagall was introduced in Congress, the so called "Proxmire Financial Modernization Act of 1988", but did not make it through the House, again. Scholars attempted to understand why bills kept failing in either the House or the Senate through the 1980s. One of the reasons is certainly to be found in partisanship in Congress, but even when one party held the majority in both houses, bills did fail. Uncovering the reasons behind this could be subject to a separate PhD. However, it is important to note that Fed's regulatory policy change, which the courts confirmed, probably had an impact on coalition building in Congress: members of the House and Senators whose districts had important bank holding companies would have had an increased incentive to act, as the Fed was already "reforming" Glass Steagall". This subject area warrants further research.

5.4 THE END OF VOLCKER

Still under Volcker's Chairmanship, the Federal Reserve Board received an application from The Chase Manhattan Corporation New York that went one step further than Bankers Trust. Chase applied to **place** commercial paper, as granted to

Bankers Trust, *as well as* to **underwrite** and **deal** in third-party commercial paper. During the public comment period, the SIA lodged its opposition to the proposal. The Federal Reserve, however, granted Chase permission to its application after weighing up the public benefits and potential adverse affects. The Board believed that "the proposed activity involved little additional risk or new conflict of interest" and since "only the nation's largest and financially strongest corporation borrow funds in the commercial paper market" and because "the proposed activities would only be a minor part of the business of a well-capitalised, separate subsidiary", the Fed granted permission and – in line with earlier decisions – imposed a long list of conditions, including the 5% thresholds as with Bankers Trust (Federal Reserve, 1987c). The Board unanimously voted for this motion and the order became effective on 18 March 1987. Chairman Volcker was absent and did not vote.

Encouraged by the Fed's amendments to financial regulation, especially regarding commercial paper, and the courts' confirmations of these, Citicorp, J.P. Morgan and Bankers Trust applied for permission to underwrite and deal in municipal revenue bonds, mortgage related securities, consumer receivable securities and commercial paper. The application thus asked for far-reaching new permissions to trade in a whole range of ineligible securities.

The Fed responded to the applications in an unusually long commentary (32 pages), published on 30 April 1987. In the response, the Fed highlighted that it did not take any initiative in pursuing the recent considerable regulatory changes, but "applicants' member bank affiliates seek to activate until now dormant provisions in section 20 of the Glass Steagall Act to participate in underwriting and dealing in certain securities, so long as they are not engaged principally in this activity" (Federal Reserve, 1987b, p. 475). The Board went on to stress that "prior to this time, there apparently has been no incentive to test the meaning of this authorization" (ibid). Suarez and Kolodny's research clearly did not cover the Federal Reserve Bulletins. They argued that "in a puzzling decision, the Fed – which was still under the chairmanship of Paul Volcker – granted the banks' request as long as the securities activities did not exceed 5% of the subsidiary's total revenue" (Suarez & Kolodny, 2011, p. 85). Not only did the Fed explain very clearly why they granted permission, but the authors also got the percentage wrong. The Federal Reserve proposed, "with respect to the appropriate level of ineligible activity permitted under section 20, the

Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between five to ten per cent of its total gross revenues. The Board also believes that a similar range should apply to the market test it believes is appropriate under section 20" (Federal Reserve, 1987b, p. 475).

The Board of the Federal Reserve was at pains to justify its decision-making on this occasion. In contrast to the vast majority of much shorter amendments and explanations, the Board gave detailed reasoning, often with additional legal and economic aspects. The Fed believed that the activities proposed by the applicants could be conducted safely and soundly without undue risk. A further, crucial difference to earlier court decisions is the Board's understanding that the underwriting and dealing in US government securities does not count towards the concept of 'securities' within the 'principally engaged' rule. In other words, the Board allowed these subsidiaries to count these activities against the 'ineligible security' activities. Also for the first time, the Board expressed concerns with the Bank Holding Companies declining profitability, and stated that

> the evidence seems to indicate that without this authority banking organisations will be at a disadvantage in the competition to supply the credit needs of the most creditworthy borrowers with access to the less costly commercial paper market, with a consequent continuing decline in the overall quality of bank loan portfolios (Federal Reserve, 1987b, p. 477).

As before, the Board ran the 'closely related to banking' activity tests and concluded that "subject to the limitations established in the Order, approval of each of the three applications would not result in a violation of the Glass Steagall Act and would be consistent with the closely related and proper incident to banking standards of section 4(c)(8) of the Bank Holding Company Act" (ibid). As with earlier decisions, the Securities Industry Association was bitterly opposed to any further amendments, especially this one, as it would finally undermine the Glass Steagall separation. The SIA contested the definition of the term 'engaged principally' once more.

Interestingly, and for the first time on such an occasion, the Federal Reserve's Board was divided during the voting process. Chairman Volcker and Governor Angell voted **against** the amendment, but they were out-voted by Governors Johnson, Seger and Heller. Despite some newspaper commentary about partisanship within the Board, the votes did not reflect party lines. Governors Johnson and Seger are Republican, but Heller is independent. On the votes against the amendment, Chairman Volcker is a Democrat, yet Governor Angnell is Republican. Angell and Volcker issued a supplementary statement of dissent with the Fed's decision. They support "the idea that affiliates of bank holding companies underwrite and deal in commercial paper, municipal revenue bonds, and 1-4 family mortgage-related securities, the activities involved in the Board's decisions" and they support the Board's limitations placed on the applicants, (ibid, p. 505). However, they disagree with the Board because

> we believe the plain words of the statute, read together with earlier Supreme Court and circuit court opinions, as we understand them, indicate that government securities are indeed "securities" within the meaning of section 20. Consequently, it appears to us that the applications approved today, as a matter of law, involve affiliations of member banks with corporations that are in fact not only 'principally engaged' in dealing and underwriting in securities, but in fact would be wholly engaged in such activities, thereby exceeding the authority of law. Our point is not merely one of legal formalisms. The interpretations adopted by the majority would appear to make feasible, as a matter of law if not Board policy, the affiliations of banks with some of the principal underwriting firms or investment houses of the country. Such a legal result, we feel, is inconsistent with the intent of Congress in passing the Glass Steagall Act (ibid, p. 505).

In response, the Securities Industry Association started its most important and one of its lengthiest legal battles with the Federal Reserve. The United States Court of Appeals for the Second Circuit started litigation proceedings in June 1987, the same month that President Reagan nominated Alan Greenspan to succeed Volcker as

Chairman of the Federal Reserve. The U.S. Senate confirmed Greenspan in August. Under Volcker, the Fed was more akin to a recipient of banks' requests in order to be granted permissions to enter certain, clearly limited areas of investment banking. The Board then attempted to interpret the letter of law and, as argued before, the courts mostly confirmed the Fed's amendments. The Fed was acting fully within its statutory authority and the courts were confirming it. Overall, then, the Fed under Chairman Volcker was a prime example in bringing about significant regulatory change without legislative change. As a result, the impasse in Congress of passing a repeal or reform of Glass Steagall did not impact the BHCs. However, it negatively affected the US investment banks – contrary to the claims made in the IPE literature.

5.5 CONCLUSIONS

The Fed under Paul Volcker went from being a regulator, ensuring that the rules of the game are followed, to one that shaped and re-interpreted the rules. As we know from the author's interviews with key decision-makers as well as the comments the Fed received during public consultations, the Fed was in a steady dialogue with Bank Holding Companies, who provided it with privileged, expert information. Two of the thesis hypotheses on interest groups can thus be easily tested and verified, namely the expert information hypothesis and the provision of information hypothesis. Despite the New York Fed being a market counterparty on Wall Street, the depth and breadth of Bank Holding Companies' information was essential for the Federal Reserve in assessing the status quo of the industry and to better understand the potential impact of the section 20 and principally engaged rulings. The paper from JPM is just one such example. Was JP Morgan lobbying the Fed to allow it to ease the restrictions on tapping investment banking markets? The answer is a clear yes. However, this lobbying was without the exchange of any money and without a revolving door: it was restricted to an open exchange of expert information which allowed the Fed to better assess the risk and return profiles of certain industry requests and to triangulate the industry's information with its own data. Moreover, it was the provision of this information and the ongoing dialogue the Fed entertained with its regulated entities which was important in making the Board comfortable with granting the permissions it did, for example, the direct reference the Fed made in relation to the declining profitability of commercial banking. Lobbying was effective "not when money was exchanged, lobbying was effective when reliable, sound expert information could be gained and people built a reputation for themselves as being subject matter experts" (GRa, 2010). The revolving door hypothesis could not be tested in this case study, as the Fed really was more careerists [?] than the other regulators, and very few top Fed staff jumped ship to the industry – a fact that would remain true throughout the entire period under consideration (i.e. 1970 to 2008).

The judiciary played, once again, a key role. As the "judiciary as regulator" hypothesis shows, the courts established a body of case law on the subject of Glass Steagall that added more information and detail as to the interpretation of this act. Moreover, and of critical importance, is the fact that a banking act from the year 1933 is now interpreted in conjunction with other, more recent court decisions, such as the national courier decision. As a result, Glass Steagall is being assessed in the context of these rulings which re-defines its meaning in a more 'modern way'. In doing so, the judiciary is confirming as well as guiding the direction of regulatory change.

Analysing this case study through the lens of the statutory authority hypothesis, it is interesting that the Fed successfully managed to establish regulatory change without legislative change. This was made possible because it had the statutory authority to respond to the amendments the Bank Holding Companies asked for in a thoughtful and careful manner. It was thus within its authority and in a powerful position when it was challenged in front of the courts. Moreover, as the comments received during the public consultation period with respect to Bank of America's acquisition of Charles Schwab show, the ideational consensus amongst regulators as well as the banking community was in favour of the Fed.

The role of ideas hypothesis is thus of importance here, as the Federal Reserve not only acted within the boundaries of its statutory authority, but was also acting with the ideational support of at least more than just its own regulatory constituency. However, it was within the Fed itself that the issue of ideational support appears to have been most conflicted. Volcker's abstaining from votes as well as the dissents (which as Chairman carry enormous symbolic weight) point towards a paradigm change within the Fed: Volcker believed in achieving more efficient and competitive markets, but not at all costs. Greenspan's Chairmanship changed this dynamic dramatically, which the next and last case study on the long road to Gramm Leach Bliley will show.

CHAPTER 6

THE FED UNDER GREENSPAN & REPEAL OF GLASS STEAGALL

6.1 INTRODUCTION

The Fed under Alan Greenspan had evolved tremendously from the Fed that issued the notice in the 1970s about its intention to amend Regulation Y to allow Bank Holding Companies to offer investment advice to investment companies. It was a very different animal. Whilst the Fed's mandate did not change, its interpretation of the legislative acts that underpin the institution's statutory authority and ultimately regime of financial regulation changed; as the three case studies have shown, the Fed gradually moved from being a bank regulator, policing the rules of the game, towards a more 'activist' stance in bringing about desirable regulatory outcomes without the legislative change that ought to underpin them.

Initially, as the first case study discussed, the Fed in the 1970s amended Regulation Y, as its staff had conducted a thorough analysis and deeply believed that these activities would be 'closely related to banking'. As such, the Fed did not challenge the separation between investment and commercial banking, but simply sought to widen the net for Bank Holding Companies' permissible business activities. It was the US Supreme Court's interpretation of the legislative intent of the Congress that had passed Glass Steagall in 1933 that turned a court case about Regulation Y into a landmark decision. From the Fed's perspective, this was unintentional and came as a surprise. The Supreme Court re-drew the lines separating investment from commercial banking, and turned the definition 'principally engaged' into a litmus test for how much investment banking business was legally permissible for Bank Holding Companies.

Initially, Chairman Volcker saw the Supreme Court's decision in a positive light. He regarded it as an opportunity to enhance the US financial market's competitiveness and efficiency. However, as bank holding companies requested to re-enter ever more areas of traditional investment banking activities, Volcker urged Congress to act, as he feared that market boundaries and effective regulations were breaking down, which would ultimately cause the loss of capital. A disconnect built up between Volcker's public statements, where he expressed ever greater discomfort about the situation, and the Fed sanctioning the re-entry of Bank Holding Companies into investment banking. By 1987, the gap between Volcker's ideas about Glass Steagall and that of the Fed's Board had grown so wide that the dissent spilled over into the public with Volcker and Agnell's statement of dissent. Under Greenspan, the Fed would move from bringing about regulatory change without legislative adjustment towards wanting to actively change the financial market structure of US (investment) banking. The Fed under Greenspan became synonymous with favouring market-based regulation on the basis of the efficient market hypothesis. So much so that "because Greenspan really believed in free market it influenced how things are done at the Fed" (ML, 2010). In Greenspan's own words: "I still found the broader philosophy of unfettered market competition compelling, as I do to this day" (Alan Greenspan, 2008).

6.2 GREENSPAN AND THE CHANGING OF THE US FINANCIAL MARKET STRUCTURE

In his first testimony to the House Subcommittee on Financial Institutions Supervisions, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, Greenspan said that "it would be appropriate at this time to concentrate attention on the specific suggestion to repeal the Glass Steagall Act" (Greenspan, 1987). He argued that financial markets had changed significantly, both in the US as well as abroad. Repealing Glass Steagall would "permit banks to operate in areas where they already have considerable experience and expertise" (ibid). Whilst a repeal would increase the risks in the markets overall, this would be manageable and "would provide significant public benefits" (ibid). The Fed would prefer a complete overhaul of Glass Steagall "to the piecemeal removal of restrictions on underwriting and dealing in specific types of securities such as revenue bonds or commercial paper" (ibid). The latter would "artificially distort capital markets and prevent financial institutions from assuring benefits to customers by maximizing their competitive advantage in particular markets" (ibid).

In his testimony, Greenspan elucidated upon the pros and cons of allowing banks to re-enter investment banking, and he emphasised that "the risks of investment banking to depositary institutions are containable, that the regulatory framework established in the securities laws minimises the impact of conflicts of interest" (ibid). In a remarkable statement, when seen through the lens of the numerous bank and investment bank failures in the US during the late 1920s and early 1930s, Greenspan argued that Bank Holding Companies would "be effectively insulated from their securities affiliates through an appropriate framework" that included deposit insurance and access to the Federal Reserve's discount window, both of which would "avoid the potential panic withdrawals from banks if affiliated securities firms experience losses" (Greenspan, 1987). As Greenspan writes in one of his more recent works, "I had long argued that the Glass Steagall Act was based on faulty history" because "only when computers made it possible to evaluate the banking system as a whole did it become evident that banks with securities affiliates had weathered the 1930s crisis better than those without" (Alan Greenspan, 2008).

In his first testimony as Fed Chairman, Greenspan stressed that the public benefits, in terms of lower customer costs and increased competition, would outweigh the adverse affects. This is because only a handful of top tier investment banks hold the majority of the market-share in most investment banking products, whilst on the flipside, commercial banks' profits were in decline. Since one of the Fed's mandates is to ensure the stability of the banking system, the Fed has an interest in Bank Holding Companies being profitable. The focus of Bank Holding Companies is on their soundness and profitability, in other words "the result is that the commercial banks and the regulators are joined at the hip" (WW, 2010). By contrast, the SEC "does not really care whether the ibanks make money as the capital rules are aimed at liquidating you overnight and give money back to investors – the relationship with the SEC was arm's-length" (ibid).

Greenspan emphasised that he wanted the Bank Holding Companies to be more profitable, and he would use its statutory authority to interpret Glass Steagall in such way as to grant the BHCs' requests to enter highly profitable areas of investment banking on the condition that their affiliates or subsidiaries would not become principally engaged in those lines of business.

Add to that the fact that "Greenspan really, really just believed in free markets - so he carried it forward and he was in favour of Glass Steagall cutting back, which he carried forward as well" (SB, 2010). According to former Fed staff, the Fed was already moving away from just following the letter of the law of the acts that make up the financial regulatory regime in the US to "interpreting the meaning of those letters to the limit which Volcker did not like, but was clearly no longer able to stop" towards pushing through meanings that were in line with "free market, the efficient market hypothesis" (ibid). This process gained momentum when Volcker left such that the Fed was fully in "favour of Glass Steagall repeal" when Greenspan took over (ibid). In this process, the New York Fed, which had trading desks on Wall Street and understood the markets well and was in favour of BHCs operating in securities markets, tilted the ideological balance towards its favour so that the historically more cautious Washington Fed fell in line with Greenspan (ibid).

Nevertheless, it took a further twelve years for Congress to pass Gramm Leach Bliley. One of the reasons no bill made it past Congress was the relative importance of Bank Holding Companies and investment banks for certain key Senate and House Seats, so the balance never swung into one direction or the other, as a repeal was clearly not in the interest of Wall Street. Whilst commercial banks kept making

> "strong pleas to Congressmen to try to get them to repeal Glass Steagall, the investment banks were equally important to the House and Senate representative of certain key states, such as New York, and managed to make their voice heard loud and clear which in turn kept the Bank Holding Companies from pushing through the repeal because the investment banks actually wanted to maintain the separation" (OJ, 2010).

The importance of the investment banks and bank holding companies as employers in the respective Senate and House seats played a key role, as any "important employer for a constituency would" (ibid). Asked whether Wall Street trumped the Bank Holding companies in campaign contributions, the "answer is no –

they were pretty equal" (ibid). When looking at contributions to Congressmen, because of the importance and size of both industries, it is not clear which lobby group is 'more powerful', but 'Wall Street' is certainly not the Leviathan that many IPE scholars thought it is; in fact, investment banks were regularly outspent by Bank Holding Companies as lobbying records from opensecrets reveal.

As a former Federal Reserve lawyer argues

> "the Fed's real concern were the courts: If you read the original section 20 orders, because the Fed knew that they would be taken to court and they thought they did 5% just to be super safe, but they said in the order that 10% is probably ok. And the courts said it is fine and we don't see a problem with 10% and immediately after that the Fed moved it to 10%" (ibid).

6.2.1 A Political Economy Analysis Of Greenspan's 'Takeover' Of The Fed

Alan Greenspan let no time pass to leave his mark on the Federal Reserve. He took office as Chairman on August, 11th 1987 and gave his testimony before the Subcommittee on Financial Institutions Supervision, Regulation & Insurance of the House Committee on Banking, Finance & Urban Affairs on November, 18th 1987, during which he made the above statements. The statements were such a sharp departure from the Volcker years that one could argue that he conducted a 'take-over' of the Fed; at least those Federal Reserve Member banks and departments which had previously felt as uneasy about the piecemeal 'regulatory change without legislative' approach as Volcker did. Though only three months in office, he made it clear to people – if they had not known it before – that he "had no time for pro regulation research papers or discussions" (ML, 2010). In light of these facts, the author tests two of the thesis's hypotheses already: first, the statutory authority hypothesis can be tested, as Greenspan essentially told the investment banking industry that the Fed would continue to let bank holding companies enter investment banking activities via piecemeal regulatory change based on the statutory authority of the Fed in the absence of significant legislative change. In his testimony, he said he 'preferred' a big regulatory overhaul to the status quo. However, given the distortions Glass Steagall caused in capital markets despite the fact that bank holding companies had expertise and experience in investment banking, Greenspan publicly justified why the Fed had to continue its policy of piecemeal regulatory change: it was in the public's and consumer's interest, and a clear declaration of war on the investment banking industry. The second hypothesis that is worth testing is the role of ideas hypothesis: as current and former Fed staff said during interviews (and Greenspan himself stated in public): the idea of the efficient market hypothesis and the concept of market-based rather than government-imposed regulation had been deeply ingrained in Greenspan, so much so that it impacted what type of issues, research papers and people knew 'he had time for'. With respect to the Fed's interpretation of Glass Steagall, if Greenspan could not get his 'preferred' regulatory overhaul through a bill passed in Congress, he would continue pursuing the piecemeal strategy in order to bring about freer and more efficient markets.

6.3 THE SECURITIES INDUSTRY ASSOCIATION'S FINAL BATTLE

The United States Court of Appeals for the Second Circuit started the hearing process on the 23rd of June 1987.[1] The Securities Industry Association (SIA) petitioned to review the Federal Reserve's Board order regarding the applications by the BHCs to underwrite and deal in municipal revenue bonds, mortgage-related securities, and commercial paper. The SIA's lawyers argued that the Fed's approval was in clear violation of section 20 and that previously bank-eligible securities have to count towards the concept of securities when considering section 20, whereas the Fed excluded them. SIA's point was not just a mere technical one: by excluding previously bank-eligible securities, it gave Bank Holding Companies much more room to manoeuvre before reaching the revenue limits of the section 20 subsidiaries' 'principally engaged' tests. If the previously bank-eligible securities were to be included, they would have to be deducted from the rest of the subsidiaries' 20 business in investment banking and thus reduce the market volume. The SIA challenged the Fed's meaning of 'principally engaged', whereby the Fed used revenue and market share tests to define this term to mean 'substantially'. The SIA argued that the term 'principally engaged' meant that the Bank Holding Company affiliate had an

[1] (United States Court of Appeals for the Second Circuit, 1988)

integral and regularly occurring part of their business in underwriting and dealing. All these points of contention might be technical, but had a major impact on how much investment banking business Bank Holding Companies affiliates were allowed to execute.

The court ruled on the 8th of February 1988 that “the Board’s Section 20 interpretation was reasonable and that its decision was to be upheld” (United States Court of Appeals for the Second Circuit, 1988). The judges agreed with the Fed after conducting its own legislative and historical analysis that

> the term ‘securities’ in section 20 only referred to bank ineligible securities since underwriting and dealing in government securities posed no hazards to banks themselves, the court held that bank affiliates should be able principally to engage in the same activity (ibid).

Even more striking is the court’s decision to eliminate the market share test/limitation that the Fed imposed, thereby only leaving the revenue limitation in force. In sum

> the court denied the petitions for review of the Board’s decisions to permit bank subsidiaries to underwrite and deal in municipal revenue bonds, mortgage-related securities, and commercial paper. It was not Congress’s plan to forbid affiliates from activities that banks themselves could engage in without limitation (ibid).

Subsequently, the Federal Reserve raised the revenue limits for Section 20 subsidiaries to 10% in September 1989 reflecting the court’s decision-making (Federal Reserve, 1989).

The Securities Industry Association was not giving up and continued the litigation process. It approached the United States Court of Appeals for the District of Columbia Circuit and appealed the previous ruling. The proceedings started on 6th March 1990, and the court decided less than a month later on April 10th, 1990. The SIA reiterated its claims and included a range of other arguments against Bank Holding Companies’ investment banking activities – some of these were more spurious. For example, the SIA alleged that banks would lack the negotiation skills necessary for conducting investment banking business, since government securities would only ever be sold via a competitive process.

The United States Court of Appeals for the District of Columbia Circuit made a firm rebuttal highlighting that "petitioner was barred by the doctrine of collateral estoppel from re-litigating the claims it lost before the Second Circuit, because the questions before the court were the same, and the national importance of the issues did not justify re-examination"[2]. The court emphasised that

> the petitioner's argument was weak on the merits because of the deference the court was obliged to give the Board's determination that the activities proposed were closely related to banking, and the Board's view was supported by substantial evidence (United States Court of Appeals for the District of Columbia Circuit, 1990).

Around the same time as the court order was published, media reports indicated that the SIA would drop its opposition to the repeal of Glass Steagall and work with regulators instead to feed back comments on a new regulatory framework. On December 1st 1989, the Wall Street Journal reported that "a secret campaign by three influential Wall Street investment banks led to the securities industry's startling move to consider dropping its longstanding fight to keep banks out of the securities business" (Winkler & Power, 1989). The newspaper article continues to report that "top Wall Street executives have concluded that banks are already winning their battle to gain securities powers with help from the Federal Reserve and from a string of court orders knocking away the barriers prohibiting them from the securities business" (Winkler & Power, 1989).

Indeed, the SIA abolished its longstanding opposition against Glass Steagall reform on the day of its annual convention. The Financial Times reported that

> the SIA would accept changes in the law to allow subsidiaries of commercial banks to offer a broad range of securities and securities-related activities […] in return it would seek […] permission for its

[2] (United States Court of Appeals for the District of Columbia Circuit, 1990)

> members to offer consumer banking services and to borrow from the Federal Reserve system in emergencies (Oram, 1989).

The FT article highlighted that

> for years the SIA has fought all the way to the Supreme Court to preserve the division between the two banking industries laid down in the 1933 Glass Steagall Act but despite the SIA's efforts, courts and regulators have granted commercial banks significant new power in such areas as corporate bond underwriting, commercial paper and securitisation of assets (Oram, 1989).

In the end, even a powerful lobby group like the SIA had to give in and stop its opposition to Glass Steagall repeal as a result of the decisions by the courts (SAn, 2010). As the New York Times observed, this happened despite the fact that "the securities association has spent millions of dollars in a decade-long effort to fight any attempt to weaken the Glass Steagall Act" (Eichenwald, 1989). Indeed, the SIA tried to block any legislative reform as much as the Bank Holding Companies pushed for the repeal. Interviewing a former senior officer of the SIA, he argued that the SIA's mandate was to "to continue to preserve the Glass Steagall distinction between investment banking and commercial banking, which they did for 20 years" (BS, 2010)

He explained "a bill would pass the House and die in the Senate and vice versa depending on who controlled it as neither one of the two separate House committees wanted to get rid of Glass Steagall, whilst the Senate wanted the repeal" (ibid). However, the SIA was not successful in winning the court cases it brought against the Fed in relation to the Fed's interpretative rulings of Glass Steagall. As a result, "we at the SIA decided to stop the litigation as the Fed simply undercut the process by expanding the definition of principally engaged" (ibid).

Losing this last court case against the Fed was the 'final nail in the coffin' for the SIA's campaign (ibid). The Federal Reserve, as predicted (or threatened, depending on which side one stands) by Greenspan in his first testimony in the House in 1987, continued to pursue piecemeal regulatory change on the basis of its statutory duty (and authority) to review and interpret the relevant laws. It is thus a prime example for the statutory authority hypothesis. However, one can also successfully test the judiciary as a regulator hypothesis, since the courts were the ones who had to opine whether the Federal Reserve's interpretations of the law were correct and within its statutory authority. The interplay of these actors – the Fed and the Courts – had brought about significant regulatory change without Congress passing any new laws.

6.4 THE FINAL ROAD TO GRAMM LEACH BLILEY

The Federal Reserve Board under Alan Greenspan continued to oppose Glass Steagall and worked towards undermining the separation of Glass Steagall. For nearly four years, the Federal Reserve proposed no considerable amendments to Section 20. It was only in January 1993 that the Fed introduced an alternative revenue test for calculating section 20 revenues. This alternative method was indexed to track changes in interest rates since 1989. In this order, the Fed argued

> the Board took this action in response to historically unusual changes in the level and structure of interest rates, which have distorted the revenue test as a measure of the relative importance of ineligible securities activities in a manner that was not anticipated when the Board established the 10 percent limit in September 1989 (Federal Reserve, 1993).

In particular, "short-term interest rates had declined sharply in recent months but that there had been very little corresponding decline in longer term rates, producing an unusually wide difference between short- and long-term rates"(ibid). What is striking is that the Fed Board was split in its vote on this issue. Chairman Greenspan and Governors Kelley, LaWare, Lindsey, and Phillips voted for it, but Governors Mullins and Angell against. Mullins and Angell published a statement of dissent emphasising that the revenue test was unreliable and thus "the Board should directly consider an increase in the 10 percent level" since it has "a considerable degree of latitude in selecting the appropriate quantitative level for applying the engaged principally standard" (ibid). However, both tests were tantamount to an increase in the revenue limits: the first test could produce results that are greater than the old 10% limit in case the index and the markets move upwards. The dissenters' suggestion would also lift the limit and be more transparent as it is not linked to an index. Congress continued its impasse and not passing legislation even after the SIA dropped its opposition to Glass Steagall's repeal. Several bills calling for the repeal of Glass Steagall were introduced in both the House and the Senate, but none of them was passed, meaning the legislative stalemate lasted until Gramm Leach Bliley.

The Federal Reserve filed a notice on July 31st, 1996 that it proposed to increase the revenue limit from underwriting and dealing in securities for section 20 subsidiaries, i.e. the subsidiary of a Bank Holding Company that engages in investment banking activities, from 10% to 25% (Federal Reserve, 1997). The notice stated that

> based on its experience supervising these subsidiaries and developments in the securities markets since the revenue limitation was adopted in 1987, the Board has concluded that a company earning 25 percent or less of its revenue from underwriting and dealing would not be engaged principally in that activity for purposes of section 20 (ibid)

The new revenue limit would be effective from March 6th, 1997. The notice gives insights into Fed's motives and thinking. Accordingly,

> the Board stated its belief that the limitation of 10 percent of total revenue it adopted in 1987, without benefit of this experience, had unduly restricted the underwriting and dealing activity of section 20 subsidiaries […] whilst the product mix that section 20 subsidiaries are permitted to offer and developments in the securities markets had affected the relationship between revenue and activity since 1987 (ibid, p.8).

The Fed received 42 public comments in response to its proposal: 26 comments from Bank Holding Companies and their industry associations, three from investment banks, one from the SIA with the remainder from other groups, such as Congressmen and think tanks. Of all comments, 34 were in favour of the Fed's proposal, eight were against it; in terms of industry, the banking industry comments were typically supportive of the proposal, with several asking the Fed to increase the limit to 49% instead of 25%. The comments from investment banks were opposed to the SIA linking the adoption of the revenue limit increase with a potential failure to achieve comprehensive financial regulatory reform. For the SIA, "the adoption of the proposed increase in the revenue limit to 25% would significantly decrease the likelihood that Congress could continue to develop the broad-based consensus necessary to enact comprehensive financial services modernisation legislation" (SIA, 1996).

Moreover, the SIA was concerned that raising the limit to 25% before a repeal of Glass Steagall was signed into law would mean that "banks and bank affiliates will have little or no incentive to support a financial services modernisation bill, because they would have received by rule much of the relief they would have sought in legislation" (ibid). The SIA went on to highlight that securities, insurance and other financial services firms would be placed at a competitive disadvantage with respect to banks, because many of these firms still would be unable to affiliate with a bank, or accept deposits (ibid).

Finally, the SIA argued that the Fed "lacked the authority" to increase the revenue limit to 25% as this would allow banks to acquire "some of the largest and most prominent" investment banks since "it is likely that many of these firms – particularly in light of their broad and diversified activities – do not derive more than 25% of their revenues from bank-ineligible securities underwriting and dealing activities" (ibid). In a direct reference to the Fed's policy of regulatory reform through the courts without legislative reform, the SIA stressed that the Fed may "disagree with the lines drawn by the Glass-Steagall Act, and may believe that perhaps no such lines should have been drawn at all" (ibid). However, "the Board cannot redraw those lines on its own authority, only Congress has that power" (ibid).

Having received all comments, the Fed stated that the interpretation of section 20 was challenging because of "intrinsically ambiguous language and further inquiry into the legislative history is therefore necessary to interpret it" (Federal Reserve, 1997). The Fed believed that although Glass Steagall was enacted to separate investment from commercial banking, "the express language of section 20 clearly allows some level of investment banking for bank affiliates" (ibid). The dismissed criticism that a review of its section 20 subsidiaries' revenue limits would negatively impact industry and Congress's efforts to pass a comprehensive reform package for financial services regulation. To the contrary, the Fed is "exercising its statutory responsibility to administer section 20 in light of significant changes to the securities markets in the years since the Board first analyzed its term" (ibid).

Consequently, "after considering the comments received, the Board has decided to adopt the proposal and amend its section 20 orders to allow up to 25 percent of total revenue to be earned from underwriting and dealing in bank-ineligible securities" (ibid).

Ultimately, this Federal Reserve decision "gave Congress the final push it needed as it allowed pretty much any investment bank to be acquired by a Bank Holding Company without the reverse being possible" (MC, 2010). The investment banks had finally lost out to the Bank Holding Companies. Gramm Leach Bliley was thus brought under way in Congress, not because BHC needed to acquire investment banks, but because they wanted to acquire insurance companies (LR, 2011). As one senior US government official involved in coordinating the Gramm Leach Bliley Act for the Clinton administration put it during an interview

> really most people believed that GLB was shooting a dead horse as the exceptions were so large anyhow and the banks were doing it anyhow […] the only institution that really, really wanted that bill was Citigroup which needed the bill in order to make the acquisition of Travellers legal, but really at the time there was not any other bank that really wanted to be in the insurance business (LR, 2011).

Senator Phil Gramm introduced 'S.900' – The Gramm Leach Bliley Act (GLB) on April 28th, 1999 in the US Senate where it was considered by the Senate Committee on Banking, Housing and Urban Affairs. It passed the Senate on May 6th, 1999 and passed the House of Representatives as the 'Financial Services Act of 1999' on the 1st of July. President Clinton signed the Act into law on November 12th, 1999. Gramm Leach Bliley was the culmination of years of legislative haggling. It broke the legislative deadlock and gave US financial institutions greater operational flexibility to be active in insurance, banking and securities as one financial services firm. Ironically, as the head of a leading New York law firms put it during the interview, "by the time the barriers between insurance and banking were taken down, this business model was no longer pursued – you had a move away from the one stop shop" (WM, 2010). This 'one stop shop' was meant to provide US customers with more choice and better priced products thanks to an increase in market competition. In some ways though, the GLB finally provided a legislative basis for the enormous regulatory and structural changes that had been the realities on the ground in investment banking.

6.5 A POLITICAL ECONOMY ANALYSIS

Testing the statutory authority hypothesis, according to former Fed officials "the Fed knew exactly what they were doing, they wanted to broaden the revenue limit and the type of test for the limit so that Merrill Lynch would satisfy the 25%" (SB, 2010). In order to justify increasing the revenue limit, his former colleagues "came up with a rather clever analysis" whereby the original 10% revenue limit is appropriate when interest rates were higher and equity markets lower so that you could earn more eligible income which would in turn put a break on how much business you could execute (ibid). However, once interest rates came down and equity market prices had gone up, which they did in the 1990s, "the numbers are at a lack and 10% does not allow them to do the same amount of business as they would be allowed to do so they moved it up to 25%" (ibid).

The Fed was now not only interested in BHC being able to re-enter certain areas of investment banking activity, this time "the main motivation was just to let them in", i.e. allow BHCs being able to acquire entire investment banks (ibid): "we worked on the first deal: Bankers Trust (a BHC) acquiring Alex Brown (an investment bank); and we worked on the second one: Bank of America buying Robert Stephens – and it was because of the of the Act that this could happen" (ibid).

Applying the thesis's conceptual framework, the Fed was ruthlessly pushing through its statutory authority – in line with the dissertation's statutory authority hypothesis – in order to undermine, bit by bit, the Glass Steagall Act with the ultimate goal of achieving more flexible, freer and thus competitive markets. In providing a specifically tailored definition to the term 'principally engaged', coupled with raising the revenue threshold, the Fed deliberately cracked open the US investment banking markets; in the absence of legislative change, the Fed essentially created the possibility for BHC to extensively participate in US investment banking markets through Mergers & Acquisitions, i.e. the revenue threshold of 25% was carefully calibrated so that an acquisition of an entire investment bank by a BHC was made legal. At the same time, the Fed also used its statutory authority to bring about an ever more challenging status quo of financial regulation in the US and entice Congress to act. The Fed was guided by Greenspan's ideology in free, efficient markets. Greenspan did not hide his distaste of Glass Steagall when he started as Federal Reserve Chairman. He could now finish his mission with the increase of the limit to 25%, as it would de-facto erase the separating line between Bank Holding Companies and investment banks, at least for the former, if not for latter. Applying the role of ideas hypothesis, it is clear that Alan Greenspan's influence on the Fed and his ideology were all pervasive at the Fed – right from the start. It is thus fair to argue that the Fed used its statutory authority to fulfil Alan Greenspan's vision.

The investment banking industry was clearly shocked about the Fed's move, as they did not expect the Fed to raise the revenue limit to a percentage point whereby some of Wall Street's key players could be bought by Bank Holding Companies despite Glass Steagall still being in place. The SIA was also extremely irritated that the Fed pursued the increase in the revenue limit during the ongoing deliberations in Congress with respect to Glass Steagall's repeal. In the words of one of Washington's most senior attorneys specialised in financial services regulation, "I think the investment banks fucked up GLB, but not the way you think" (MC, 2010). There were two ways to do Gramm Leach Bliley: first, one could approach financial reform as expanding existing banking powers, i.e. the authority and activities that Bank Holding Companies could do; or, second, you could repeal the Bank Holding Company Act (ibid).

When it was clear that the repeal of Glass Steagall was becoming a real possibility, it could be "one of these two ways: keep the Bank Hold Company Act and expand the powers by getting rid of Glass Steagall and the inability to own insurance companies or you could say, we are not going to have the BHC Act at all" (ibid).

The Bank Holding Company Act was "like a fence, but if you were outside it – like the investment banks – and you thought about it, you do not want to go in it, because you were able to do all kinds of things outside the fence, such as merchant banking, investments etc. etc." (ibid). Senator D'amato introduced a bill that would have repealed the BHC Act "and then there was Leach's bill, which was a Fed bill, he was called 'Fedo-phile', he loved the Fed and the Fed loved the BHC Act and Bob Rubin became Secretary of the Treasury and the administration could have gone either way" (ibid). The investment banking community formed a group to review both bills and they "proposed this investment banking holding company and supported going down the road of Leach, which we passed as GLB. Guess who made use of the Investment Banking Holding Company? Not a single investment bank" (ibid).

Testing the dissertation's interest group-based hypotheses through the lens of the investment banking community – expert information, provision of information and the revolving door –it becomes clear that none of them influenced the regulatory decision-making in this case study, i.e. the widening of Bank Holding Companies' access to investment banking. The investment banking community had been very vocal about the impact of the Fed's regulatory decision and provided input during consultation periods as well as in the media, but without an impact. Likewise, there was no revolving door between the investment banks and the Federal Reserve, at least not at the level of the elites.

In line with the judiciary as a regulator hypothesis, Bank Holding Companies benefited from the de-regulatory moves by the Fed, the investment banks had no levers to fight back within their own turf since the US courts upheld that the Fed's interpretative amendments of the Glass Steagall Act were within the legislative intent. In other words, a regulatory regime that is built on the regulator's statutory authority and confirmed through the courts can only be changed through the legislative.

6.6 CONCLUDING REMARKS ON THE GLASS STEAGALL CASE STUDIES

The three case studies have traced back the levers and factors that ultimately led to the passage of the Gramm Leach Bliley Act, Glass Steagall's repeal. Each of the cases focussed on a distinct episode of Glass Steagall's repeal that was unique and would not repeat itself in the following cases:

1. The pre-Volcker years case study examined a deregulatory episode by which the Fed amended Regulation Y (Supreme Court of the United States, 1971). When the ICI took the Fed to court, neither the plaintiff nor the defendant would have been able to predict that the US Supreme Court would look at their case as setting precedent and thus needing to provide a detailed ruling on the legislative intent of Glass Steagall that ultimately kicked off the process of the Glass Steagall's demise. This case study is important as it highlights how the judiciary can dramatically alter the meaning and interpretation of laws, so much so that it brings about significant regulatory change without any legislative change. Here, the US Supreme Court provided two new key pieces of information: first, the line separating investment from commercial banking is to be found within the Bank Holding Company, namely between the Parent Company and its affiliate engaged in investment banking; second, the Congress that passed Glass Steagall did not have such an expansive view of the separation between investment and commercial banking in mind, but one whereby a bank's affiliate or subsidiary can be active within investment banking markets for as long as it is not principally engaged. The thesis's explanatory variables of statutory authority and the 'judiciary being a regulator' are particular important in understanding this event of de-regulation, namely a widening of the legally permissible business activities of Bank Holding Companies.

2. The second case on Glass Steagall studied the Fed under the Volcker years. Here, the Federal Reserve is best classified as an institution in ideological transition with a Chairman that became increasingly uncomfortable with the newfound power of regulatory change by virtue of its statutory authority to interpret and amend existing laws which are then upheld in the courts. Because the Fed was concerned about the low profitability of Bank Holding Companies and the lack of competition in the highly profitable investment banking markets, the thesis's explanatory variable of the role of ideas helps explain why the Fed felt justified in using its statutory authority to provide a definition for the term 'principally engaged' which was upheld in the courts, became part of the case law and subsequently allowed BHCs to re-enter investment banking markets via separate affiliates, as long as these affiliates

were not 'principally engaged'. Volcker, who was initially comfortable with this as it helped BHCs to be more profitable (which, in turn, is not the mandate of the Fed, but intricately linked with its mandate of banking stability) and gave consumers greater choice and better prices, grew more and more sceptical over time. He disliked the automatism of the process by which the Fed would provide updated interpretations of banking rules that it saw compatible with the Supreme Court's interpretation of Glass Steagall, which meant that BHC were becoming more and more entrenched in investment banking markets. Towards the latter years of his Chairmanship, Volcker became more at odds with the rest of the Federal Reserve Board over this issue. He saw it as problematic and costly not to have Congress pass new regulation. As the case study showed, the Fed was in ideological transition: as an institution, it became more and more subscribed to the efficient market hypothesis. Ultimately, Volcker resigned from the Fed: he had grown apart and disagreed publicly with the Fed's decision on commercial paper (States, 1986).

3. The final case study, the Fed under Greenspan, is a distinct episode in that Alan Greenspan took over the sceptre at the Fed and immediately made his mark: within weeks, he testified that the Fed would be in favour for Glass Steagall's repeal. It was a declaration of war to the investment banking industry. During the same testimony in Congress as Fed Chairman, Greenspan not only provided the public essentially with an assessment of the situation under the Glass Steagall regulatory regime; he also made a strong case that bank holding companies should be allowed to operate in investment banking markets, and that any risks could be managed through the deposit insurance scheme as well as access to the discount window so that, overall, the public benefits would be greater than the risks. The role of ideas – namely those associated with the efficient market hypothesis – became a dominating factor within the Fed's internal governance as well as its stance towards regulation. This is in line with the thesis's role of ideas hypothesis. Greenspan made it clear from the very beginning of his tenure that he would 'prefer' a repeal of Glass Steagall, but at the same time implied that he would go down the route of using the Fed's statutory authority to break down Glass Steagall in a

> piecemeal fashion. Under Greenspan, the Fed took its statutory authority to the extreme, and felt reassured that its decisions would be upheld in the courts, which they were. Because of the Fed's ideological consensus that was increasingly pro market self-discipline, Greenspan and the Board felt justified in pushing their statutory authority with respect to section 20's interpretation to the extreme. Ultimately, the combination of an ideational consensus coupled with the authority and the back up of the courts made for a powerful cocktail that eventually brought down Glass Steagall and forced Congress to react.

Overall, then, the story of the repeal of Glass Steagall is a complex one. It is a story of de-regulation, but it is also a story of an epic Wall Street defeat, and as such runs counter to conventional wisdom in both media and academia as the literature review demonstrated.

Hans Trees
SGIA, Durham University

Chapter 7

CFMA 2000: THE POLITICAL ECONOMY OF NOT REGULATING OTC DERIVATIVES

7.1 INTRODUCTION

The political economy of the Commodity Future Modernisation Act of 2000 (CFMA) is fascinating: all key actors in financial regulation, the Clinton Administration, the Senate, the House and all US financial regulators, with the initial exception of the U.S. Commodities and Futures Trading Commission (CFTC), were in consensus that it was necessary to pass a bill that explicitly outlawed the regulation of a wide range of over-the-counter (OTC) derivatives markets. It was one of the key episodes in US financial history where one had a broad policy consensus – driven by the idea that markets can regulate themselves – across the political spectrum, government, regulators and industry that culminated in the CFMA legislation. The main regulator of large segments of OTC derivatives markets, the CFTC, played a near- tragic role under Chairwoman Brooksley Born. As a relatively young regulator, founded in 1974, it originally focussed on regulating the agricultural and commodity exchanges and trades. With the rapid speed of innovation and financialisation of commodity markets – especially in the segment of OTC derivatives - the regulatory framework in the US for off-exchange transactions could not keep up, which meant that the key actors and markets developed offshore and not in the US. The CFTC, even though it had no statutory authority to establish a regulatory regime of regulation – or exemption thereof – for OTC derivatives, wanted to provide market participants with legal certainty so they could develop these innovative markets as well. The Commission published a policy statement in 1989 that it would not enforce regulation on certain OTC derivatives, such as swaps. However, lacking statutory authority, the judiciary ruled an OTC derivatives case in 1990 that interpreted the then existing regulatory framework covering OTC derivatives, the Commodity Exchange Act, such that forwards would be classified as futures and had to be traded on exchange and not OTC, as otherwise they would be deemed illegal and unenforceable instruments.

Despite the court ruling, the CFTC issued an 'interpretative statement' telling markets that though the courts had decided, the regulator would not enforce the court's decision. In response, Congress acted and passed legislation in 1992 that gave the CFTC statutory authority to exempt certain OTC derivatives from regulation, which it then promptly did. As the OTC derivatives markets continued to develop rapidly both in terms of product offering and size, the SEC was confronted with a similar situation as the CFTC was in the 1980s, namely that key US investment banks would execute trades offshore due to domestic regulation being too burdensome. The SEC proposed a 'Broker Dealer Lite' regime that allowed well-capitalised US investment banks to establish OTC derivative trading subsidiaries in the US that benefited from reduced capital and reporting rules. It was this SEC rule proposal that set in motion a chain of events at the CFTC that would see its Chairperson go against the rest of the US regulatory and legislative community, which was unified by their belief in the superiority of self-regulating markets and the innovative powers thereof. The case study examines with process tracing the steps and decision points that ultimately led to the resignation of Ms. Born and the passage of CFMA.

7.2 THE OUTCOME

Ten days before Christmas Eve 2000, the US House of Representatives passed H.R. 5660, also known as the Commodity Futures Modernisation Act of 2000 (USA Congress 2000); the US Senate followed the day after, and President Clinton signed the bill into law on December 21st , 2000. CFMA has been the outcome of what is a best described as a short, but eventful two years of regulators, legislators, the industry and the US Treasury Sectary being at loggerheads not with each other, but predominantly with another regulator, the Commodity Futures Trading Commission (CFTC) and its Chair, Ms. Brooksley Born.

CFMA focussed on the regulation, or non-regulation, of over-the-counter (OTC) derivatives and futures in the United States. A derivative, by way of a definition, is a financial contract for either the purchase or sale of one or more underlying assets (i.e. currencies, commodities, debt capital market products etc.) and whose value is derived from the performance of these underlying assets. Common financial derivatives instruments are: forwards (i.e. a contract to buy/sell a specified asset at a specified time in the future at a price agreed upon when signing the contract), futures (i.e. a more standardised forward contract), options (i.e. a contract that gives the buyer the option, but not the obligation to buy or sell a specified asset or liability), and swaps (i.e. a contract between two parties whereby both swap the cash flows of each other's financial instruments). An OTC derivative is a financial instrument that is not traded through an exchange or a regulated market, but on a bilateral basis between two parties and thus off-exchange (hence over the counter).

The bill's preamble states that CFMA was introduced to Congress "to reauthorise and amend the Commodity Exchange Act to promote legal certainty, enhance competition, and reduce systemic risk in markets for futures and over the counter derivatives, and for other purposes" (USA Congress 2000). The Act established several areas of explicit non-regulation for a range of market counterparties and financial instruments: certain derivatives, swaps and commodities were thus explicitly not being regulated – it was forbidden by law to do so. With respect to these derivative transactions, "nothing in this Act governs or applies to an agreement, contract or transaction in an excluded commodity" as long as these transactions are between "eligible contract participants at the time" (USA Congress 2000, p.36). Eligible participants were defined as individuals with more than $5m in assets entering into transactions for risk management purposes (USA Congress 2000, p.17). Security hybrid instruments were also expressly excluded from regulation: "nothing in the Act governs or is applicable to a hybrid instrument that is predominantly a security" (USA Congress 2000, p.38). With respect to swap transactions,

> no provision of this Act shall apply to or govern any agreement, contract, or transaction in a commodity other than an agricultural commodity if the agreement, control or transaction is (1) entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract or transaction; (2) subject to individual negotiation by the parties; and (3) not executed or traded on a trading facility (ibid).

But Congress went further in relation to the non-regulation of swaps – it not only excluded swaps from regulation as the above statement reflects, but also forbade the SEC from regulating security-based swaps

> the Commission is prohibited from registering, or requiring, recommending, or suggesting, the registration under this title of any security-based swap agreement […]. The Commission is prohibited from (A) promulgating, interpreting, or enforcing rules; or (B) issuing orders of general applicability; under this title in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement (ibid, p.237)

In sum, the CFMA excluded all off-exchange Swap transactions between sophisticated investors from any regulation, and in doing so provided legal certainty that these transactions were in line with US regulation. This intentional act of non-regulation was approved 292-60 yea to nay votes in the House of Representatives, and in the US Senate by 'unanimous consent'. Weeks before, the White House proclaimed that it 'strongly supported' the bill, and it was important for it to be enacted this year (N.B.: 2000) to "promote innovation, enhance the transparency and efficiency of derivative markets, maintain the competitiveness of U.S. businesses and markets, and, potentially, reduce systemic risk" otherwise, these markets would go offshore to countries with "more updated regulatory regimes" (President William Clinton 2000).

7.3 PROCESS TRACING OF CFMA'S HISTORICAL ROOTS

7.3.1 The Beginnings

CFMA 2000 significantly changed the Commodity Exchange Act of 1936 (CEA). The CEA, which itself made considerable amendments to the Grain Futures Act of 1922, moved the entire US commodity trade onto registered exchanges and required commodity traders to register with the authorities. The CEA managed to remove barriers to commodity trade between US states, and introduced curbs to what the CEA refers to as 'excessive speculation' and 'excessive trading' – both long and short – with the aim to limit price and market manipulation (US Congress 1936). From then onwards, trades had to be recorded and records had to be kept for Federal Inspections. A government agency was created within the US Department of Agriculture, the Commodity Exchange Authority, which acted as regulator until the Commodity Futures Trading Commission Act of 1974 established the CFTC as an independent federal regulator. In the 'House Report' of the US House of Representatives, the Act was praised as

> a major legislation strengthening the federal regulation of the nation's 400 billion dollar commodity futures trading industry [and..] provides the first complete overhaul of the Commodity Exchange Act since its inception, and proposes a comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex (Congress 1974, p.4).

The newly established CFTC not only took over powers from the US Department of Agriculture, but also had the authority to act in market emergencies, a fact that the derivatives industry challenged, but the courts upheld. The CFTC had to deal with many market emergencies throughout the 1970s, 1980s and 1990s. During the same period, the CFTC's regulatory remit had become more complex as a result of the industry inventing more and more innovative derivative and future products. For example, in 1977, the CFTC approved the first futures contract on long-term U.S. government debt, and in 1982, the first option on future contracts. Because of industry innovation, the CFTC's area of jurisdiction started to overlap with that of the Securities and Exchange Commission (SEC). The chairs of both commissions became active and developed a CFTC/SEC Jurisdictional Accord, also known by the chairmen's names: the 'Shad-Johnson Accord'. The Accord clarified the respective regulatory responsibilities of the CFTC and the SEC: the SEC would regulate options on securities (both corporate and municipal), foreign exchange traded on national securities exchanges and certificates of deposits; the CFTC would regulate future contracts (and option on future contracts), broad-based indices of equities and foreign exchange options not traded on national securities exchanges (US Congress 1982). Congress integrated this Accord into their legislative process and passed the Futures

Trading Act of 1982, signed into law by President Reagan. Besides the CFTC/SEC jurisdictional clarification, the Act renewed the CFTC's mandate, legalised the trading of options on agricultural commodities and banned future contracts on single stocks and narrow-based equity indices.

7.4 THE SWAP POLICY STATEMENT

In a much-overlooked statement – both in the media as well as IPE academia alike – the CFTC issued a 'Swap Policy Statement' in 1989 in which the CFTC wrote that "most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA" (CFTC 1989). Nevertheless, the CFTC provided a 'safe harbour': it stated that it would not classify certain swap agreements as future contracts within the meaning of the CEA, meaning these swaps would not be regulated as futures and could thus be traded off exchange, i.e. over the counter (ibid). The CFTC did not provide a concise definition of which swap agreements would fall under this safe harbour, but stated that these agreements ought to be negotiated individually (as opposed to off the shelf products), settled in cash, between two parties and based on cash flows "measured by different interest rates, exchange rates, or prices, with payments calculated by reference to a principal base" (ibid). Moreover, the agreements had to reflect that the specific business activities of the contractual parties should only be terminable with counterparty consent and thus hold on to maturity and not be marketed to the public. Several issues arose with respect to the Statement: firstly, it did not provide clear guidance as towhich parties were permitted to enter into swap agreements, such as high net worth individuals (i.e. 'sophisticated investors') or collective investment vehicles that offer share participation to the public. Secondly, the CFTC lacked statutory authority to determine whether or not certain futures would be exempt from regulation under the CEA; thirdly, the statement gave the industry some comfort, but it was open to be challenged in the courts. It was thus the CFTC itself that intentionally placed a vast amount of swap agreements outside its own and any other regulators' supervision, and it did so despite lacking the statutory authority.

A year later, a ruling in a judicial case that had started in 1986 and concluded in 1990 showed the limits to the CFTC's policy statement, and once again highlighted the importance of the courts in upholding as well as re-defining financial regulatory laws. Bermuda-based Transnor sued British Petroleum (BP), Conoco, Shell and Exxon for losses it suffered in the Brent Oil market on the grounds of the CEA's anti-manipulation provisions. The defendants argued that the derivatives instruments the parties entered into were forwards, and as such not covered by the CEA. The US District Court for the Southern District of New York disagreed with the defendants' claim and argued that these specific forwards, but more generally all highly standardised forwards, were to be classified as futures (S.D.N.Y. 1990). In response, the CFTC issued a 'Statutory Interpretation Concerning Forward Transactions' that the Brent Oil forwards would fall under the CEA's forward exclusion and were – contrary to the Court's ruling – not futures (CFTC 1990). The situation was really a standoff between the Courts and the CFTC, and one that the CFTC could not win given its lack of statutory authority. This court ruling unnerved market participants who felt that the US regulatory regime was unable to provide them with legal certainty. The choice was thus between having fewer and fewer OTC derivatives markets in the US, and regulatory reform through the enactment of new laws.

Congress became active, and committee hearings began on the 'The Futures Trading Practises Act of 1992' in early 1991. After much deliberation and changes to the original proposal introduced to the House and Senate, the Act was signed into law in October 1992. It authorised the CFTC to grant exemptions from regulation for OTC derivatives, such as swaps and hybrid instruments, under the CEA in 1992 (US Congress 1992). In the words of President Bush Senior, "the bill [...] gives the CFTC exemptive authority to remove the cloud of legal uncertainty over the financial instruments known as swap agreements. This uncertainty has threatened to disrupt the huge, global market for these transactions" (President George Bush 1992). Interestingly, the bill itself did not define whether a swap agreement is a future contract or not, but simply deferred this task to the CFTC via its newfound statutory authority. Within months, the CFTC used its authority and published exemptions from regulation for certain OTC hybrid and swap agreements. Swaps between eligible swap participants (i.e. institutions and sophisticated investors) that were non-standardised (i.e. 'not part of a fungible class of agreements that are standardised as to their material terms'), not traded on a “multilateral transaction execution facility” continued to be exempted, and the creditworthiness of the counterparties is a “material consideration in entering into or determining the terms of the swap agreement, including pricing, cost or credit enhancement terms” (US Congress 1992**).** Swaps meeting these criteria were exempted from being regulated as futures, but not from the CFTC’s anti-manipulation and anti-fraud authority. Bizarrely, the CFTC emphasised in its Swap Exemption that it wished to enhance legal certainty, but that the issuance of the Swap Exemption ought not to be interpreted as a CFTC decision that swap agreements are not subject to regulation under the CEA.

7.4.1 A Political Economy Analysis of The Swap Policy Statement

The Policy Statement is a clear episode of intentional non-regulation for eligible swaps. Since there was no public comment period, we do not have official records of industry groups commenting on this statement. However, as one interviewee recalls, who was the General Counsel to the Securities Industry Association at the time

> the CFTC was concerned that the legal uncertainty would deter business from the US offshore and prevent innovation; they had all the US commodity exchanges come in and complain to them that banks can be in the derivatives business offshore, but they cannot profit from it in the US (MP 2010).

The author cannot extensively test the Provision of Information Hypothesis or the Expert Information Hypothesis, but the information received from elite interviews with former CFTC staff does suggest that industry experts were providing the CFTC with information on a regular basis. The interviewee confirmed that the industry presented the CFTC with data and studies “all the time”, and that the legal uncertainty hanging over the industry’s head as to when a swap could be classified as a future that had to be traded on exchange “gave them sleepless nights and made them take the business to Europe” (ibid). With respect to the Revolving Door Hypothesis, the CFTC is probably one of the prime examples, as several CFTC commissioners on the Board at the time had spent part of their previous careers in the industry they were regulating, such as banks and agricultural commodity traders (such as William E.

Seale, Kalo A. Hineman, Robert R. Davies and others). The CFTC was "not a respected agency on the Hill – it had far less budget and staff than the SEC – but US Presidents recruited its Commissioner often from strong industry backgrounds, which somehow helped overcome the other resources gaps" (ibid). Interestingly the CFTC issued its statement knowing that it had no statutory authority to provide a safe harbour, but nevertheless, its statement did assuage markets, as it

> removed the legal risk that the CFTC would take enforcement action against certain swaps, but it did not remove the legal risk that a swaps counterparty might try to have a court invalidate a swap as an illegal, off-exchange futures contract (US GAO 1997).

The subsequent court's ruling questioned the legality of the CFTC's swap policy statement: because of the absence of the statutory authority, the courts are ultimately deciding what is compatible with the legislative intent of the CEA. The CFTC's interpretation statement was a bizarre attempt at calming down the markets and providing them with the certainty that the CFTC would not enforce Brent Oil forwards as future contracts; however, any party entering into such contracts would also have known that the counterparty could question the legality of the instruments and would win in court. From a political economy lens, it was a very odd situation: the CFTC had to accept the court ruling, but nevertheless issued a statement that it decided not to apply it, and this despite not having the statutory authority to make such 'interpretations' in the first place. Ultimately, anyone could have challenged the CFTC on its interpretation, but no one did. The stalemate between the regulator and the courts created a situation in which Congress needed to act, and they did so with the passing of the Futures Trading Practises Act.

7.5 THE SEC'S MOVE

President Clinton appointed Ms. Brooksley Born to the CFTC in April 1994, and she became Chairperson on August 26th 1996. US Congress and President Clinton re-authorised the CFTC in 1995 for five years without making any changes to the CEA. On December 17th, 1997, the SEC published a proposed rule that would amend the Securities Exchange Act of 1934

> would tailor capital, margin, and other broker-dealer regulatory requirements to a class of registered dealers, called OTC derivatives dealers, active in over-the-counter derivatives markets […] intended to allow securities firms to establish dealer affiliates that would be able to compete more effectively against banks and foreign dealers in global over-the-counter markets (Securities Exchange Commission 2007).

The proposed rule would offer investment banks that are mainly active in privately negotiated OTC derivatives transactions an alternative registration regime and avoid a registration as an SEC regulated investment bank. The SEC acknowledged that because of the regulatory and capital burden involved as being fully registered as an SEC regulated investment bank, many investment banks had moved their OTC derivatives trading offshore:

> the capital and margin requirements applicable registered broker-dealers […] impose substantial costs on the operation of an OTC derivatives business and make it difficult for U.S. securities firms to compete effectively with banks and foreign dealers in OTC derivatives markets (ibid).

US investment banks should thus not be pushed to offshore their business “solely to address competitive disadvantages that result from Commission regulation” (ibid). The proposed SEC rule gave US investment banks the optionality to benefit from “limited” broker-dealer regulation for their OTC derivatives business only. These limited regulations included: exemption from certain margin requirements, exemption from becoming a member of a Self-Regulatory-Organisation, such as national stock exchanges (i.e. the New York Stock Exchange) and an amended net capital rule. Under the existing net capital rule requirements, unsecured receivables had to be deducted in full when calculating excess net capital, whilst this included interest rate derivatives as well as any unrealised gains on swaps. At the same time, investment banks were not allowed to offset their OTC derivatives positions if possible (and as commercial banks were allowed to) so that, overall, they were forced to hold more capital than non-US investment banks or commercial banks that were allowed to use VaR models.

The SEC thus proposed to allow OTC derivatives dealers to add back any trading gains and unsecured receivables from OTC derivatives to their assets and "use VaR models to compute their capital charges on proprietary positions instead of taking haircuts on them as required under the current rule" (ibid). However, the SEC proposed that an OTC derivative dealer had to maintain $100m tentative net capital and $20m net capital at all times and operate appropriate internal risk management systems. Echoing many elements that would later be included in the SEC's alternative net capital rule and Consolidated Supervised Entities Programme of 2004, the SEC argued for a "flexible approach for determining capital requirements" that accounts for the "special nature" of OTC derivatives business and takes account of international developments and the Basel Accord (ibid).

With the proposed rule, the SEC wanted to offer regulatory and financial incentives for these investment banks with a regime that was less 'burdensome', hence in the industry, the proposed rule became known as 'broker dealer lite'. In its release, the Commission emphasised that because of the innovation and creativity in OTC derivatives, "some of these products may cross regulatory boundaries" (ibid). Whilst investment banks transacting in OTC derivatives in securities which were regulated as part of the Securities Exchange Act were already under SEC regulation, those investment banks that were only active in non-securities OTC derivatives or commercial banks would not fall under any SEC regulation, thereby putting full SEC registered OTC derivatives dealers at a competitive disadvantage and driving their business offshore: "the proposed rules […] are intended to improve the efficiency and competitiveness of U.S. securities firms participating in global OTC derivatives markets […] be deregulatory and […] impose fewer costs" (ibid). However, the SEC made it clear that it did not want a 'race to the bottom' in terms of regulatory capital, such that the "regulation as an OTC derivatives dealer would be available only to large, well-capitalized firms" (ibid).

The SEC received six comment letters: three from industry association ("The Committee on Federal Regulation of Securities" of the American Bar Association, the Securities Industry Association ("SIA") and the End-Users of Derivatives Association "EUDA"), two from industry participants (Goldman, Sachs and D.E. Shaw) and one from a US regulator (the CFTC). The American Bar Association was in support of the rule, but argued London or Zurich were used as off-shore locations because the net capital rule "has distorted capital flows by causing OTC derivatives creation to be expatriated to countries that have been more flexible" since "the costs of […] net capital rule exceed the benefits" (American Bankers Association 1997). They recommended "to exempt entirely from the net capital rule all derivatives dealers that do not hold customers' funds or securities" (ibid)**.** The SIA "strongly endorsed" the rule, but cautioned that VaR models should also be allowed to calculate credit risk, that OTC dealers should not be limited in their non-securities activities and simplify the capital and risk management standards (Securities Industry Association 1997)**.**

EUDA's feedback was much more cautious, arguing that it would like to better understand the split between SEC and CFTC jurisdiction, especially with respect to anti-fraud authority, and it recommended that "our members should have an opportunity to review and consider the comments submitted to the SEC by the CFTC on matters affecting the CFTC's jurisdiction over 'non-securities' OTC derivatives" (End-Users of Derivatives Association 1997)**.** Goldman Sachs "enthusiastically supports the initiative taken by the Commission in proposing rules that would permit registration of an OTC derivatives dealer", endorsed the comments from the SIA and "does not believe that the Commission's proposals encroach in any way on CFTC jurisdiction, as the CFTC and others have suggested in comment letters to the Commission" (Goldman Sachs 1997). The hedge fund DE Shaw was supportive of the initiative, but very critical of some of the proposed rule's details and stressed that $100m tentative net capital was too much and would not address the anti-competitive nature of the current regime (D.E. Shaw 1997)**.**

The CFTC commented as well. It stated that the SEC proposal "extends beyond the SEC's authority to regulate securities" which spans only "a small percentage of the overall volume of the OTC derivatives market - approximately 1.4% of the notional value of total derivatives contracts outstanding in early 1995 are subject to SEC authority" (CFTC 1997). Despite this, the "SEC's proposal would attempt to regulate the large number of OTC derivatives transactions beyond its jurisdiction, many of which are subject to the exclusive statutory authority of the CFTC". As a result, it would cause a "specter of future regulatory inconsistency", various conflicts with the Commodity Exchange Act (CEA) and create gaps as well as inconsistencies in the proposed treatment of OTC derivatives dealers - "both as currently set forth and as modified in the future in response to developments in the rapidly changing OTC market" (ibid).

The letter went on to accuse the SEC that its proposed rule would "ignore the applicability of the CEA" and create an additional layer of regulation so that "market participants could be in full compliance with SEC regulations but in violation of the CEA and CFTC regulations, or vice versa" (ibid.). In this context, the letter highlighted that the SEC's proposal definitions might be in congruence with the then current CFTC regulation and exemptions, but because the CFTC "has both the power and the statutory obligation to update its regulations in light of market developments" this could cause legal uncertainty going forward. The letter gave specific examples of where the SEC's proposal conflicted directly with the CEA, such as the SEC's definition of eligible OTC derivative instruments which would be similar, but not the same as the CFTC's. Consequently, transactions permissible under SEC's proposed rules would not be exempted under CFTC provisions, and these "transactions entered into in reliance on the SEC's standards for OTC derivatives dealers might be illegal if not within an exemption from the CEA" (ibid). The CFTC letter stressed throughout that "the CFTC has the statutory mandate to oversee the markets for instruments designed primarily to shift risk among parties" and that "Congress recognized and reaffirmed this point in 1992 when it granted the CFTC authority to exempt certain instruments, including OTC derivatives" (ibid). It concluded by urging the SEC to limit this regulatory initiative and to work jointly with the CFTC "to craft a coordinated and comprehensive approach to the OTC market that avoids duplicative, inconsistent regulation" (ibid). The CFTC also disclosed in its letter for the first time that it was already in the process of developing a reform agenda for OTC derivatives regulation (or exemption thereof) given the significant growth and innovation in this segment. To this end, it would issue a "concept release" shortly and conduct a public consultation to gather the views from "across the spectrum" of people from the industry as well as regulators who would have "ample opportunity to provide input" (ibid). In a further criticism of the SEC, any regulatory reforms that were to be proposed would consider the views of all parties involved, including other regulators so as to avoid conflicts and overlaps. Any reform would "seek to ensure the continued growth and innovation in the OTC derivatives market as well as to protect customer interests and market integrity" (ibid).

The SEC was not surprised that the CFTC would seek to defend its turf, but "we thought that the wording of its comment letter was somewhat terse and defensive" (NA 2010). From interviews with key decision-makers at the SEC, it is clear that the SEC was especially taken aback by the CFTC's announcement that would issue a concept release: "for nearly four years, Ms. Born and the CFTC neither gave an indication nor reached out to us that it was contemplating regulatory reform of the OTC derivatives markets; it was as if our proposed rule was a wake-up call for them" (CR 2010). The SEC's OTC Derivatives Dealers proposal was driven by the fact "that you no longer had a level playing field: our investment banks had stricter capital requirements than US commercial banks and the European and Japanese ibanks", as a result of which "our guys just took their business offshore". Moreover, "we disliked not knowing what our investment banks were up to in derivatives, because it was done from abroad". According to the interviewees, "we believed that our capital regime was becoming outdated, you know, others could use VaR models, our guys could not" and the "pendulum that was swinging towards greater market self-regulation, the idea that sophisticated investors would be able to look after themselves and use state of the art risk management techniques" (ibid). The SEC was thus driven by levelling the playing field, a belief that this market was highly innovative with transactions between sophisticated investors, and not regulatory turf wars: "of course we expected the CFTC to get irritated somewhat, but we very careful to tailor our proposal to derivatives of securities only" (ibid).

7.5.1 A Political Economy Analysis of the SEC's Derivatives Dealers Rule

The SEC's proposed and enacted Derivatives Dealers Rule is a further case of deliberate de-regulation. US investment banks had become important players in the OTC derivatives markets, but chose to execute their trades offshore because of the regulatory burden associated with the SEC broker dealer regulation. As the comments during the public consultation process highlight, investment banks and their industry association group, the SIA, were 'enthusiastic' about the SEC's proposal and strongly supported it. The proposed rule addressed highly complex subject matter that had to account for the SEC's regulatory regime, the CFTC's regulatory regime and the unfolding Basel Accords. The commentators thus provided very detailed feedback, as can be seen, for example, by the SIA's letter, that was of tremendous importance to the SEC. The industry and its legal counsels were often in a situation where they could draw from business experience, such as operating OTC derivatives trading operations in Europe, which the SEC did not have, but which was intended to support the SEC in adapting its rules to the realities on the ground. As such, we can test both the Expert Information Hypothesis and the Provision of Information Hypothesis positively, and conclude that the provision of this privileged information to the SEC from interest groups was vital for the process.

The role of ideas hypothesis can also be tested and confirmed. The SEC emphasised in its proposed rule, as did the senior SEC officials during the interview, that they did not simply want to 'lure' investment banks' OTC business back to the US. Rather, they believed that the use of VaR models was 'state of the art' risk management, and they also believed that the 'well capitalised' investment banks were sophisticated enough, by virtue of self as well as market discipline, to be allowed to operate OTC derivatives trading in the US within a regulatory regime that was less burdensome administratively, but also from a net capital perspective.

With respect to the statutory authority and the mandate of the SEC, this episode of de-regulation is particularly interesting, as it involves a potential clash of two regulators, both of which had statutory authority over OTC derivatives market segments that were in theory clearly defined, but in practice subject to increasing interpretation as markets became ever more innovative. The SEC's establishment of a Derivatives Dealers Regime, also known as 'Broker Lite', was thus strongly rebutted by the CFTC whose comment letter argued that the SEC's proposed rules would cause confusion and legal uncertainty. The revolving door hypothesis is not testable on this particular case, as the elites involved did not switch industries.

7.6 THE CONCEPT RELEASE

In the months between the SEC's publication of its proposed rule for OTC Derivatives Dealers in December 1997 and the publication of the CFTC's concept release on May 7th, 1998, the CFTC was finalising the draft of its concept release. Prior to the release, Chairperson Born presented some key aspects of the release at the National Futures Association annual conference in Florida in March 1998 (Brooksley Born 1998). The vast majority of industry feedback during that conference was negative, with one investment banker calling the concept release a 'death knell' to the swaps market (Lucchetti A. Schroeder 1998). At the same time, back in Washington, key decision-makers started to get worried about the timing and process of the Concept Release. Senator Richard Lugar, then Chairman of the US Senate Committee on Agriculture, Nutrition and Forestry – the Senate Committee holding the CFTC to account –, wrote a letter to Born asking her to hold off on publishing the concept release and instead to carefully examine the OTC derivatives markets jointly within the framework of the President Working Group (AN 2011). Born refused.

Born behaved similarly at one of the US's most high profile and powerful working groups – the President's Working Group on Financial Markets (PWG). President Reagan established the PWG in 1988 to identify and review any major issues in financial markets and provide recommendations thereof, with the aim of "enhancing the integrity, efficiency, orderliness and competitiveness of US financial markets" (President Ronald Reagan 1988). The PWG consisted of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, or his designee and the Chairman of the Commodity Futures Trading Commission, or her designee.

Treasury Secretary Robert Rubin, his deputy Larry Summers, Chairman of the Federal Reserve Alan Greenspan, Chairman of the SEC Arthur Levitt and Chair of the CFTC Brooksley Born attended the PWG meeting on April 21st, 1998 to discuss the topic of OTC derivatives regulation. According to the notes, the CFTC was preparing a concept release to seek clarification as to how to avoid OTC derivatives markets from destabilising and how better to monitor them. Born argued that she sought comments from the public and the industry alike that the concept release "does not in any way alter the current status of any instrument or transaction" (Meeting Notes

1998). Rubin warned Born that he received industry feedback, and that the financial community was "petrified" about the potential ramifications of defining swaps as futures and as such requiring them to be on-exchange traded. It would "raise uncertainty over trillions of dollars of transactions" and could render them unenforceable and illegal, thereby introducing the possibility of litigation. Greenspan stressed that "regulation should enhance the development of financial innovation [and] OTC derivatives made an important contribution" which regulation might suppress. Rubin, Levitt, Greenspan and Summers urged Born and the CFTC to think about "airing this issue differently" and to think whether there is a "better way to proceed" (ibid).

Despite these unanimous pleads, Born went ahead and the CFTC published the 'Concept Release' on May 7th, 1998 stating that the CFTC had been "engaged in a comprehensive regulatory reform effort designed to update the agency's oversight of both exchange and off exchange markets" which includes "re-examining its approach to the OTC derivatives market" (CFTC 1998). The CFTC explained the need for its release with the dramatic growth in trading volumes as well as product varieties in OTC markets that started to attract customers of various level of sophistication. The CFTC sought to gain relevant data from the public's comments that would help it determine whether "its current regulatory approach continues to be appropriate or requires modification" whilst maintaining "adequate safeguards without impairing the ability of the OTC derivatives market to continue to grow and the ability of U.S. entities to remain competitive in the global financial marketplace". In part because of the strong reaction Born received during the April 21st PWG meeting, the CFTC went out of its way to emphasise that it had "no preconceived result in mind", that it would be "open" to data supporting more regulation as well as less, and that any potential new regulation would only be applied prospectively and after seeking additional comments (ibid). Any changes would "be carefully designed to avoid unduly burdensome or duplicative regulation that might adversely affect the continued vitality of the market" (ibid).

On the issue of the 1993 CFTC swap exemption, the concept release highlighted that this exemption was in part based on the fact that the OTC derivatives market were dominated by large and sophisticated investors, and trades were decentralised and off-exchange, and thus did not provide any price functions. However, within the last five years, swap OTC derivatives markets recorded "explosive growth" with new end-users, products (some of which were more standardised) and proposals to establish centralised clearing platforms. In addition, the number of losses and their size had grown, even among sophisticated investors, so much so that "market losses by end-users may lead to allegations of fraud or misrepresentation after they enter transactions they do not fully understand" **(**ibid**).** The CFTC's sought comments to questions it asked the public in relation to the Swap exemption. For example, the CFTC asked in what ways the swap markets had changed

> with reference to the nature of the products, participants, location of transactions, business structure of participants, nature of counterparty relationships, mechanics of execution, methods for securing obligations and the impact of the current regulatory structure on any of the foregoing (ibid).

Other questions focussed on whether the definition of eligible trading participants for swap transaction should change, whether any clearing functions for swaps already exist, whether any capital requirements were needed for OTC derivatives dealers, whether all dealers should be required to register with the CFTC etc. The CFTC included 75 questions in its comment list, the majority of which addressed fundamental issues rather than specific details. This caused considerable concern in the industry which feared that the CFTC – against all statements to the contrary - planned a major overhaul of the swaps market regulation.

The concept release also included a dissenting remark from CFTC commissioner Barbara Pedersen Holum, which stated that "it appears that the dramatic growth in volume and the products offered in the OTC derivatives market may be attributed in part to the Commission's past exemptive action" (ibid). Whilst she argues that it is "appropriate" for the CFTC to examine the continued applicability of the exemptions, "the release goes beyond the scope of regulatory review by exploring regulatory areas that may be inapplicable to an OTC market" (ibid).

7.6.1 The Reaction

In what must have been an unprecedented move, the US Treasury Secretary Robert Rubin, Fed Chairman Alan Greenspan and SEC Chairman Arthur Levitt issued a joint statement on the same day of the Concept Release. They expressed their

> grave concerns about this action [the Concept Release] and its possible consequences", "seriously question the scope of the CFTC's jurisdiction in this area and [..] are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives (US Treasury Secretary Chairman of the Federal Reserve Chairman of the SEC 1998).

Rubin, Greenspan and Levitt agreed that the concept release raises "important public policy issues", however these "should be dealt with by the entire regulatory community working with Congress" (ibid). In a final blow to the CFTC, they state that they "are prepared to pursue, as appropriate, legislation that would provide greater certainty concerning the legal status of OTC derivatives" (ibid).

From then onwards, events snowballed. On June 5th, the US Treasury, the Fed and the SEC issued a joint, temporary legislative request to Congress that the PWG should conduct an in-depth study of the OTC derivatives market, and that, "prior to the enactment of legislation authorizing appropriations for the CFTC for any year after the year 2000, the CFTC shall not propose or promulgate any rule, regulation or order, or issue any interpretative or policy statement, that restricts or regulates activity in any hybrid instrument or swap agreement" (US Treasury Secretary Chairman of the Federal Reserve Chairman of the SEC 1998). On June 10th, Born testified in front of the US House of Representatives Committee on Agriculture, Subcommittee on Risk Management and Speciality Crops. It was her first testimony on this topic (Born testified in front of the US Senate Committee on Agriculture, Nutrition and Forestry on May 14th, but this was in relation to the CFTC's readiness for the "Year 2000" IT issues) in Congress since the publication of the Concept Release. It was a very combative testimony during which Born dismissed the release critics' arguments one by one. She asserted that many concerns about the release either "reflect a lack of understanding as to the nature and purpose of the release or a desire to avoid government oversight" (Born 1998). She dismissed the issue of legal certainty, claiming that "the Commission does not believe that this robust, multi-trillion dollar market is so fragile that mere governmental examination of it will cause dislocation, […] the market will benefit from assuring that government regulations do not ignore developments and innovations in the marketplace" and that "the Commission has thus sought to ensure that the Concept Release will not jeopardize the legal status or enforceability of any OTC derivative contract" (ibid). She defended the CFTC's statutory authority to review the regulation of OTC derivatives markets and stated bluntly that the claim that the CFTC lacked jurisdiction with respect to OTC derivative instruments was incorrect. The CFTC had "decades of expertise" in dealing with OTC derivatives, and she pointed to various pieces of legislation where Congress approved and acknowledged the CFTC's jurisdiction (ibid). Given the sensitivities surrounding the Concept Release and the joint statement made by the Treasury, Fed and SEC, Born's testimony – even if it were factually correct – reflected an openly aggressive stance that was not well received in Washington's political circles.

On June 16th, 1998, Republican member of the House of Representatives Jim Leach introduced a bill "to provide for the study of derivatives regulation, and for other purposes that may also be cited as 'Financial Derivatives Supervisory Improvement Act of 1998'" (Jim Leach 1998). The bill called for the establishment of a working group on financial derivatives, made up of the Secretary of the Treasury, the Federal Reserve Chairman, the Chairman of the SEC and CFTC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairperson of the Board of Directors of the Federal Deposit Insurance Corporation and the President of the Federal Reserve Bank of New York. The working group should examine derivatives market regulation from the perspective of all potential market participants – i.e. bank holding companies, investment banks and foreign banks – and present its findings in two reports. The bill wished to enhance legal certainty, and called for a moratorium imposed on the CFTC which "may not, without the approval of the Secretary of the Treasury propose or promulgate any rule, regulation, or order, or issue any interpretive or policy statement, that restricts or regulates activity in a hybrid instrument or swap agreement" (ibid). The introduction of this Bill reflected two things: firstly, a significant loss of trust by lawmakers in the abilities of the

CFTC, and secondly, the level of panic in the financial industry about the legal uncertainty in relation to swaps.

On June 18th, the CFTC extended the end of the comment period for its concept release from July 13th to September 11th. On July 17th, the House of Representatives' Committee on Banking and Financial Services held the first of two hearings concerning OTC Derivatives Market. During the first hearing, the Committee invited industry representatives and academics to testify. Most were overwhelmingly negative and concerned about the CFTC's Concept Release. Mark Brickell from JPMorgan stated that they were greatly concerned about "persistent and potentially harmful legal uncertainties surrounding the status of swaps transactions under the Commodity Exchange Act", and believed that swaps by default "cannot fit within the regulatory framework defined by the CEA", and if they were, "would instantly call into question the enforceability of thousands of swap transactions and undermine billions of dollars of transactions at American banks, brokers, and corporations" (JP Morgan 1998)**.** Dennis Oakley of Chase Manhattan Bank – then the bank with the largest derivatives portfolio worldwide – stated bluntly that "if legal uncertainty posed by CFTC assertions of jurisdiction is not removed, Chase will be forced to move this business to another location, probably London, where we don't have the specter of legal jeopardy that has been raised by the CFTC" (Chase Manhattan Bank 1998). The eminent Professor of financial regulation, John Coffee, testified that if Congress did nothing, the "OTC derivatives business will continue to flee the United States and migrate to London" despite the SEC "broker/dealer lite" proposal; but if the CFTC did retract the swap exemptions, "then the adverse consequences would become far more serious" (John Coffee 1998). Unsurprisingly, representatives from the commodity exchanges, such as the Chicago Board of Trade, the Chicago Mercantile Exchange and the New York Mercantile Exchange defended the CFTC against some of the criticisms, such as the claim that the concept release alone would cause legal uncertainty, whilst simultaneously stating that the system of non-regulation of swaps should be kept in place, but be moved on to registered exchanges, which would obviously benefit them significantly rather than allowing large parts of the markets to be off exchange.

A week later, a second hearing took place in front of the House Committee, during which mainly regulators testified. One of the most fascinating and intellectually stimulating testimonies was by Alan Greenspan. He started by "taking a step back from these issues of immediate concern to address the fundamental underlying issue, that is, whether it is appropriate to apply the Commodity Exchange Act (CEA) to over-the-counter derivatives (and, indeed, to financial derivatives generally) in order to achieve the CEA's objectives – deterring market manipulation and protecting investors" (Greenspan 1998). He argued that markets of financial instruments and their derivatives are deep, with essentially unlimited supply and thus hard to manipulate. This would be contrary to markets in derivatives based on commodities whose supply is finite and often defined by seasons. As a result of these two very different markets, "the type of regulation that is applied to crop futures appears wholly out of place and inappropriate for financial futures, whether traded on organized exchanges or over-the-counter, and accordingly, the Federal Reserve Board sees no need for it". He essentially dismissed that the CEA was relevant to OTC derivatives, and stressed that not regulating these markets as privately negotiated OTC contracts between professional counterparties demonstrated that they could protect themselves and manage their risks. Whilst he has

> no doubt derivatives losses will mushroom at the next significant downturn as will losses on holdings of other risk assets, both on and off exchange […], I see no reason to question the underlying stability of the OTC markets, or the overall effectiveness of private market discipline, or the prudential supervision of the derivatives activities of banks and other regulated participants (ibid).

Richard Lindsey, the SEC's Director of the Division of Market Regulation, testified that the SEC was concerned with a potential increase in the legal uncertainty concerning swaps and its impact on markets (SEC 1998). The SEC believed that the CFTC change of the current swap exemption could curb innovation and push further business offshore. For him and the Commission, swaps were not futures, and they had "serious doubts as to the CFTC's authority to regulate OTC markets" since "Congress gave the CFTC broad exemptive, not regulatory, authority regarding OTC swap transactions […] without making any determination regarding the status of swaps and other OTC derivative instruments under the CEA" (ibid). The SEC argued that any legislation should be jointly coordinated with the President's Working Group (PWG) as the forum.

Ms. Born's testimony raised significant concerns with the House Bill from Representative Leach: it would prevent the Commission from taking action in OTC markets, or other emergencies arising in that portion of the OTC derivatives market within its statutory authority, would forbid the Commission from enforcing its existing laws and regulations relating to certain transactions in that market, and would bar the Commission from addressing new developments in that market" (Brooksley Born 1998)**.** She argued that the Concept Release had not created any market emergency and that the CFTC had been engaged in "comprehensive regulatory reform effort designed to update, to modernize and to streamline its regulations and to eliminate undue regulatory burdens" (ibid). Ms. Born's testimony was in large part a repeat of her earlier testimony from June 10th, which was perceived as defensive as well as dismissive of the views voiced by the CFTC's critics.

On the same day and in contrast (or contradiction) to her testimony, Born conceded and told the Chairman of the House Agriculture Committee, Robert Smith, in a letter that the CFTC would not issue any new rules for over-the-counter (OTC) derivatives until Congress had the opportunity to review this market and its regulation during the CFTC's re-authorisation process in 1999. Chairman Smith thanked Born for "her leadership" and the CFTC for acting "responsibly" in delaying the review, as Congress had not determined whether swaps were futures contracts, so this "controversy could be put to bed" (Robert Smith 1998)**.**

Six days later, on July 30th, Deputy Treasury Secretary Lawrence Summers, Fed Chairman Alan Greenspan, SEC Chairman Arthur Levitt and CFTC Chair Brooksley Born testified in front of the Senate Committee on Agriculture, Nutrition, and Forestry on the subject of the regulation of OTC derivative markets. Levitt, in line with the SEC's earlier statements and testimonies, argued that the CFTC's concept release introduced the possibility of a comprehensive regulatory overhaul of the current swap and hybrids exemptions, and marked a "significant departure from the careful approach taken by the SEC and other regulators" (Arthur Levitt 1998). Such an overhaul might increase legal uncertainty, and if the CFTC concluded that swaps were futures under the CEA, it would destabilise the OTC derivatives market. Levitt said that no “convincing argument” had been made as to why the CFTC had to consider such a “vast, new scheme to regulate this market”, which he as well as most of the industry looked upon with “grave concern” (ibid)**.** He went on to stress that Congress “did not intend for the CFTC to use its exemptive powers to establish a new regulatory regime for the OTC derivatives market” (ibid). Levitt welcomed Born’s letter to hold off on any regulatory action, but believed it should have remedied any legal uncertainties caused by the concept release by explicitly stating that most swaps are not futures. Greenspan largely repeated in his testimony what he said in front of the House. Lawrence Summer gave the most critical testimony: whilst the concept release raised legitimate questions that merited study, it had cast a shadow of legal uncertainty over the OTC markets despite the fact that it was unclear whether the CFTC actually had broad jurisdictions over these markets. (Lawrence Summers 1998)**.** According to Summers, there had been “implicit consensus” that OTC derivatives markets should be left to grow based on the assumption that swaps were not subject to the CEA. For him, the concept release “upset” this “fragile consensus”: the vast amount of fundamental questions the release asked implied the possibility that CFTC was considering a deep regulatory reform that could define swaps as futures. Summers stressed that the Treasury’s concerns were not simply a “Wall Street” concern, but would affect corporates’ ability to use swaps for risk management purposes, meaning had already started shifting business offshore. He, too, welcomed Born’s letter, but with reference to the joined Fed, US Treasury and SEC request for legislation, criticised that the letter did not raise the topic of conducting a coordinated study of OTC derivative markets.

Born continued her defence: she started her testimony criticising the Treasury proposal that, if adopted, would “harm important public interests” since it would “retroactively legalise certain OTC futures contracts that have been forbidden by law since 1982”, even though the concept release had not caused any emergency (Brooksley Born 1998). Moreover, the Treasury proposal would essentially prevent and forbid the CFTC from enforcing regulations, “raise more legal questions than it resolves” and “create significant regulatory gaps by tying the Commission's hands in addressing emergencies and wrongdoing in the market” (ibid).

In what can only be retrospectively described as an error of judgement, Born argued that by having the PWG, instead of the CFTC, undertake a study of OTC derivatives market regulation, it would not only impair the CFTC's exercise of its statutory duty, but also transfer this duty to "an ad hoc coordinating body with no budget, no staff and little expertise in derivatives market regulation" – she was referring to none other than the US Treasury Secretary, the Chairman of the SEC and, at the time, Alan Greenspan, the Chairman of the Fed. Born argued that Alan Greenspan's testimony in front of the House Committee on Banking and Financial Services from July 24th, in which he argued that derivatives should not be regulated by the CEA, was "incorrect and overly narrow, and ignores that the Act and the regulations issued thereunder have been repeatedly amended over the years to address the regulatory issues raised by the tremendous growth in financial derivatives" (ibid). Born emphasised that the arguments that the CFTC lacked jurisdiction over futures and options were incorrect, and that it was absolutely within the CFTC's statutory duty to issue the concept release and, if necessary, amend the swaps exemption.

On September 11th, 1998, the CFTC extended the comment period for a second time until October 13th. Long Term Capital Management ("LTCM") – the infamous hedge fund whose founders included two Nobel laureates (Myron Scholes and Robert Merton) – collapsed on September 23rd, 1998 as a result of huge losses on its derivatives positions. Because of the systemically important nature of LTCM's position within the derivatives market, the Fed oversaw a $3.6bn dollar bailout paid for by private sector banks. Born testified on the issue of the LTCM collapse before the Senate Committee on Agriculture, Nutrition and Forestry in October 1998, and said that "the LTCM episode raises a number of important regulatory questions relating to hedge funds and to the OTC derivatives market – most of these questions are raised by the Commission in its Concept Release on OTC Derivatives" (Brooksley Born 1998).

However, despite LTCM's collapse, public opinion on derivatives market regulation did not change. Ms. Born resigned on January 19th, 1999, by announcing her intention not to seek reappointment to a second term at the end of her term in April (Brooksley Born 1999). It seemed that the private and public lobbying efforts against Ms. Borne from the highest echelons of the Federal Reserve, the US Treasury and the SEC paid off. Mr. William J. Rainer replaced Born as Chair of the CFTC. In November 1999, the PWG issued its joint report on the ‘Over-the-Counter Derivatives Markets and the Commodity Exchange Act’, in which it concluded that “under many circumstances, the trading of financial derivatives by eligible swap participants should be excluded from the CEA” and to

> remove legal impediments to the development of electronic trading systems, which have the potential to increase market liquidity and transparency, and appropriately regulated clearing systems, which can reduce systemic risk by allowing for the mutualization of risks among market participants and by facilitating offset and netting of contractual obligations” (President's Working Group 1999).

Both these recommendations were in stark contrast to what the CFTC had argued for under Born. They remained in place and became part of the CFMA 2000 Act.

7.7 CONCLUSIONS

The history and political economy of CFMA 2000 provides a rich tapestry for testing the thesis’s hypothesis. As the process tracing exercise has shown, the financial industry provided detailed financial market insights and legal feedback to proposed rules by both the CFTC and SEC, and had kept the regulators informed on an on-going basis. Given the speed and complexity with which OTC derivatives market had been developing, both regulators relied heavily on the provision of expert information. This is clearly in line with the expert information hypothesis and the provision of information hypothesis. Both the CFTC and the SEC would have struggled to fully understand the dynamics of OTC derivatives markets, as these were off-exchange and in large part outside their geographic area of jurisdiction. The OTC derivatives industry was clearly able to influence both the CFTC and SEC, and was able to make a strong case that legal certainty was needed in terms of the CFTC continuing to exempt OTC derivatives markets from regulation. They made a convincing case that the exemption was crucial in keeping markets onshore, ensuring the market’s innovative powers and making them grow. Not a single statement from the CFTC or the SEC – including the concept release – doubts the importance, the growth potential and power of innovation of OTC derivatives markets. As such, the industry could effectively lobby for its view of the world and can actually take credit for having been able to influence policy outcomes, such as the CFMA, but also the CFTC 'interpretative statement' from 1990.

With respect to the revolving door hypothesis, US Presidents had typically recruited CFTC commissioners who had deep industry knowledge, which clearly helped the regulator to better grasp these markets and their developments. However, there has been little by way of a revolving door of market actors – not lawyers – between the SEC and its regulated entities. If anything, the expert information hypothesis and provision of information hypothesis show that there were clear gaps in the technical and market knowledge at the CFTC and the SEC, which would not have been the case if these regulators had derivatives traders within their organisation. It is hard to ascertain the degree to which the revolving door between the industry and the CFTC helped in bringing about CFMA since the entire regulatory policy community, the Clinton Administration and Congress were aligned in not regulating OTC derivatives.

When testing the statutory authority hypothesis, three key learnings come out: first, absent statutory authority – as was the case for the CFTC in the area of swaps exemption prior to the enactment of the Futures Trading Practises Act in 1992 – regulators have no room to manoeuvre whenever the judiciary is being involved. They can issue statements and interpretation, but they expose themselves to being successfully challenged in the courts as they act outside their statutory boundaries. This happened to the CFTC and Congress had to step in and act. The Glass Steagall case studies showed that the judiciary can determine the boundaries of regulators' statutory authority and can provide interpretations of legislative acts; however, the CFTC case showed that regulators will not be effective in their decision-making if they are acting outside their statutory authority whilst having cases being ruled upon by the judiciary. Secondly, if certain market segments could be regulated by two different regulators, both of which have statutory authority, regulation will only be effective and accepted by market participants if both regulators jointly develop a regulatory road-map and coordinate their rules. The Shad-Johnson Accord is a positive example of this; the SEC OTC Derivatives Dealers is a negative one that caused enormous friction and legal uncertainty, as it was not coordinated with the CFTC. Third, regulators who do have statutory authority over certain issue areas and financial communities will fail to act upon it if the broader policy consensus of the industry, legislators and regulators is opposed to its actions. The CFTC was within its statutory rights to issue the Concept Release and actually amend the rules governing OTC derivatives markets. The CFTC could have abolished the swaps exemption, as it had the statutory authority to do so, and this would have most likely also stood up in the courts, which speaks in favour of the judiciary as a regulator hypothesis. However, testing the role of ideas hypothesis, the consensus not to regulate OTC derivatives was so widespread and deeply anchored among all key decision-makers in Washington as well as market participants that ultimately the CFTC lost the trust and confidence, ending up with having the power to act, but unwilling to do so in practice.

The CFTC is a particularly interesting case, as the regulator moved from not having the statutory authority to act, but being backed up by an ideational consensus shared amongst Congress and market participants alike (i.e. exempting OTC derivatives from regulation), to having the statutory authority to act, but being outside the predominant ideational consensus. In the former, the CFTC was keen to act, but could not, whilst in the latter it was authorised to act, but would not.

CHAPTER 8

THE SEC'S CONSOLIDATED SUPERVISED ENTITIES PROGRAMME

8.1 INTRODUCTION

The SEC's alternative net capital rule, which the SEC's Consolidated Supervised Entities Programme (CSE) established, has been widely blamed for allowing investment banks to leverage themselves above 12:1 leverage ratios and is said – as the literature review has shown – to be driven by Wall Street. This case study shows that these claims could not be further from the truth. It traces the origins of why the SEC established the consolidated supervised entities (CSE) programme back to the European process of ever-closer political and economic integration and the European Commission's Financial Service Action Plan (FSAP). Instead of Wall Street, European politicians and policymakers set out to build a single integrated capital market in the EU that would require financial conglomerates wanting to be active in the EU to be subject to consolidated supervision, irrespective of where their home regulator is based. Subsequently, third-country supervisory regime for financial conglomerates needed to pass an equivalence test in the EU, or else their conglomerates had to establish separately capitalised and institutionalised holding companies within the EU. Because of this legal requirement, the SEC was forced to react, and developed the CSE programme on a voluntary basis as it lacked statutory authority. The programme was built around consolidated supervision, and the SEC adapted its net capital rule to bring it more in line with international capital standards at a time when frequent discussions and meetings took place to draft up Basel II as a new capital adequacy standard. As part of this ideational consensus, it essentially lowered the capital requirements for CSEs – a clear act of deregulation – but in the firm belief that the risk management standards and internal models would actually be more robust than the standard SEC net capital rule. The SEC, which was clearly not a banking regulator, was dependent on inputs from experts – something the investment banking community was eager to provide; in a self-serving move that went beyond normal lobbying, investment banking industry experts supported the regulator in establishing a new regime that would ultimately have to be tried and tested by the

European financial supervisors. Overall, then, the case study shows that the events behind the establishment of the CSE programme and its net capital rule took a very different turn and beginning than is commonly understood in the IPE of finance.

8.2 THE OUTCOME

On August 20th, 2004, the United States Securities Exchange Commission (SEC or Commission) adopted rule amendments to the Securities Exchange Act of 1934 (the Exchange Act). These amendments created a new regulatory regime – known as the Consolidated Supervised Entities (CSE) programme – for certain eligible investment banks, as well as amended an already existing voluntary regulatory regime referred to as Supervised Investment Bank Holding Companies (SIBC), which has never been used by the industry and been steadfastly neglected by IPE scholars since its inception in 1999. As US Congress did not pass legislation to change the then existing regulation of investment banks, the SEC had no statutory authority to impose either the CSE programme on investment banks or the SIBC. Instead, the SEC established the CSE on a voluntary basis.

For the CSE Programme, the Commission changed one of the Exchange Act's key rules, Rule 15c3-1, better known as the net capital rule, and introduced an alternative method for calculating net capital for eligible investment banks.

Previously, the rule required larger investment banks to apply 'the alternative indebtedness method' and hold net capital of at least or greater than either \$250k or 2% of the investment bank's customer related receivables (i.e. cash owed by customers to the investment bank) – also defined as the base capital requirement. Smaller investment banks followed the 'basic indebtedness method', which requires investment banks to hold net capital of at least or more than \$250k or 6.67% of aggregated indebtedness, which amounts to \$1 of net capital held for every \$15 of debt.

To comply with these requirements, investment banks have to first calculate their equity according to US Generally Accepted Accounting Principles ("US GAAP") by deducting their Balance Sheet US GAAP liabilities from the US GAAP assets – both of which are marked to market on a daily basis. Thereafter, debt that is subordinated to creditors' claims, certain deferred income tax liabilities and accrued liabilities are added back to US GAAP equity before all Balance Sheet assets not deemed to be readily convertible into cash are deducted, such as fixed assets (i.e. building), intangible assets (goodwill), prepaid items (i.e. rent) and the majority of unsecured receivables (i.e. bridge loans). The sum arrived at is defined as 'tentative net capital'. In a penultimate step, haircuts are applied to security positions within the tentative net capital. These haircuts are defined in great detail and depend on the security type, its maturity, marketability and quality. For example, haircuts applied to the market value of US municipal debt securities range from 0% to 1% depending on maturity. Preferred stock carries a haircut of 10% of market value. After deducting all haircuts, the investment banks arrive at their net capital**.** Finally, the base capital requirement is deducted from the investment bank's net capital to determine its excess net capital position.

Importantly, the SEC saw the net capital rule as a liquidity test and not as a leverage ratio or capital adequacy standard. Its purpose was to protect investment banks' customers, creditors and counterparties by ensuring that investment banks were liquid enough at all times to settle all claims in a timely fashion (United States Government Accountability Office 1998). In other words, in the absence of a lender of last resort, the SEC's net capital rule was a mechanism that was not meant to protect investment banks from failing (as would be the case for commercial bank's capital standards). On the contrary, the net capital rule was meant to allow for an orderly liquidation of a failed or failing investment bank so that all counterparties, creditors and customers would speedily receive their money or investments back in full.

Under the CSE programme, the SEC allowed eligible investment banks to apply to join the programme and use an alternative method for calculating net capital that "responds to the firms' requests to align their supervisory risk management practises and regulatory capital requirements more closely" (SEC 2004). The CSE programme attempted to bring the SEC net capital rule for US investment banks more in line with the Basel II capital adequacy standard. In doing so, CSE investment banks were allowed to calculate their own deductions for certain market and credit risk positions on the basis of their own internal Value at Risk (VaR) and scenario analysis models. For market risk, the SEC allowed two new options: first, it defined, on a case-by-case basis, for which of the investment bank's positions VaR models could be used, and determined that the VaR of these positions had to be based on a ten working day movement in rates and prices and calculated using a 99% confidence interval before multiplying that result by a factor of three; second, if scenario analysis (ScA) were to be used, investment banks had to use a loss experience within the worst trading day movement over the four years preceding the greatest loss. In case of insufficient data, "the deduction shall be the largest loss within a three standard deviation movement in those risk factors, prices or spreads over a ten day period, multiplied by an appropriate liquidity adjustment factor" (ibid).

The SEC provided detailed rules on credit risk weights, many of which were shadowed along the lines of Basel II, but included marked to market on a daily basis. For example, any collateral pledged against credit had to be marked to market day-by-day, liquid and transferable and in the investment bank's control. Collateral could not be made of securities issued by the counterparty. With respect to credit risk weights, these were: 20% credit risk weight for any transactions with counterparties that had ratings for senior unsecured long-term debt or commercial paper in one of the two highest rating categories by a Nationally Recognised Statistical Rating Organisation (NRSO) such as Standard & Poor's (S&P) or equivalent; 50% credit risk weight for counterparties with the third and fourth highest rating, and 150% credit risk weight for counterparties with a rating below the fourth highest. However, investment banks could apply for SEC approval to come up with their own credit risk weights based on internal credit risk calculations for those counterparties not rated by an NRSO. All investment bank's VaR models had to fulfil a range of minimum qualitative and quantitative requirements for SEC approval.

The Commission was aware that the CSE programme's deductions for market and credit risk would likely be lower than under the standard net capital rule, thereby reducing regulatory costs for "very highly capitalised firms that have developed robust internal risk management practises", which the Commission saw as a "major benefit" (ibid). The application of mathematical models would enable investment banks to reallocate capital to areas of higher return. Specifically, the Commission estimated that investment banks applying for the CSE programme and switching to the CSE's alternative net capital method would be able to realise, on average, a reduction in capital deductions of c. 40% amounting to a total of c. $13bn for the five investment banks they believed would apply (i.e. Merrill Lynch, Lehman Brothers, Goldman Sachs, Morgan Stanley and Bear Stearns), which in turn would increase their return on equity by 20 basis points (i.e. 0.2%) by reallocating the freed up capital to more profitable business lines. In the words of one of the top aides to the Clinton Administration, "everybody thought at that time that the Basel standard, which had not been implemented, will be fine: who are we to contest the risk weights of the Basel standards and do not forget in 2004 the economy was fine, there were no signs of bubbles anywhere" (LB 2010).

However, the SEC required any eligible investment banks firstly to maintain tentative net capital of at least $1bn, secondly net capital of at least $500m, and last but not least, to notify the SEC if tentative net capital falls below $5bn, at which point the SEC would consider taking appropriate remedial action. In the words of the SEC, "this $5bn early warning requirement is based upon the staff's experience and the current levels of net capital maintained by the broker-dealers most likely to apply to use the alternative method of computing net capital" (ibid). As will be discussed later on in the chapter, the de-facto tentative net capital requirement was thus $5bn. The SEC regarded these liquidity and capital requirements as consistent with the first pillar of the then proposed New Basel Capital Accord (i.e. Basel II).

8.2.1 Eligibility and Supervision Requirements

Neither the Courts, nor the US President nor Congress bestowed the SEC with the statutory authority necessary to establish the CSE programme on a mandatory basis. The CSE programme was voluntary. In return for allowing 'very highly capitalised' investment banks to align their internal risk management more closely with actual net capital, thereby reducing their regulatory and capital burden (or increasing their balance sheet with the same amount of net capital), they agreed to have their ultimate holding companies and affiliates, collectively defined as 'consolidated supervised entities' (CSE), become subject to SEC supervision. Previously, the SEC only supervised the investment banking units based in the United States, but not the ultimate holding company of US investment banks, and had thus no visibility on the non-US investment banking activities. Supervision of those CSEs that did not have a principal regulator, either domestically, such as the Federal Reserve, or abroad, consented to (i) provide the Commission with detailed information (financial, capital and risk exposures etc.) about the holding company, (ii) comply with the CSE rules for establishing and documenting a comprehensive, group-wide risk management system, (iii) SEC examinations of the holding company and any affiliate as long as the affiliate has not principal regulator, (iii) compute and report on a monthly basis the group-wide capital position and computations for market, credit and operational risk in accordance with Basel standards.

On issues of governance, record-keeping and risk management, the CSE programme required investment banks not only to rapidly adopt many of the quantitative elements of the Basel standard for calculating market, credit and operating risk, but also to put in place a wide range of Basel's qualitative prerequisites. The latter included creating a narrative description of the business and organisation of the CSE with organisational charts, detailed accounts of the methods used to calculate market, credit and operational risk as well as comprehensive description of the risk management control system in place.

The SEC regarded all these requirements as consistent with the second pillar, supervisory review of the new Basel standard (i.e. Basel II), but the Commission did not impose additional disclosure requirements as the third pillar of Basel II, market discipline, was still being negotiated and was not finalised at the time of the establishment of the CSE. CSEs that have a principal regulator are subject to significantly less SEC supervisory requirements.

Overall, the newly established CSE programme was thus more akin to the Fed's Bank Holding Company oversight, and combined elements of the Basel capital adequacy standard with the Exchange Act's net capital rule.

The SEC also provided detailed time and costing estimates for adapting the CSE programme requirements per investment bank. These estimates ranged from the time needed to compile an investment bank's CSE application (i.e. 1'000 hours, which includes 100 hours for an in-house attorney to review the application), review models (5'600 hours), back-test models (640 hours), estimating capital allowances (1'080 hours), comply with record preservation requirement (1 hour), compile reporting requirements (120 hours) (ibid).

The SEC expected that the CSE programme would meet the EU criteria for consolidated home supervision and thus "minimise duplicative regulatory burdens on firms that do not have ultimate holding companies that have a principal regulator that are active in the EU as well as in other jurisdictions that may have similar laws" (ibid). The SEC price tag for US investment banks having to establish an EU sub-holding company was $8m per annum, which could thus be avoided. Moreover, the Commission estimated that the quantifiable benefits of the CSE were $66m per annum for all five investment banks combined against quantifiable annual costs of $10m and one-off CSE implementation cost of $90m.

8.2.2 The Supervised Investment Bank Holding Company Regime

At the same time as they set up the CSE programme, the Commission amended the already existing SIBHC regime, which was created with the Gramm Leach Bliley Act (GLB) in 1999. The chapter examines the creation of the SIBHC regime first before discussing the SEC's changes.

On November 4th, 1999, after more than a decade of lively discussions in both the House of Representatives as well the US Senate about reforming the Glass Steagall Act of 1933, US Congress passed the final bill of "An Act to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes", otherwise known, after the legislators who helped chaperone a majority of Republicans and Democrats, as the Gramm Leach Bliley Act (GLB) (USA Congress 1999). US President Clinton signed the Act into law on November 12th. The GLB Act gave a de-jure basis to the de facto reality on the ground for two decades whereby Federal Reserve regulated Bank Holding companies – i.e. commercial banks – had already re-entered investment banking territory.

In a much-overlooked section in both the academic world and the media, Subtitle C, Section 231, the GLB Act created a new type of supervision, namely that of investment bank holding companies by the SEC on an 'elected', i.e. voluntary basis. The new regulatory regime was open to investment banks whose ultimate parent was not already part of a Bank Holding Company, Savings Association or foreign banks. The supervisory regime can be seen as a forerunner to the CSE programme in some respects: it required investment bank holding companies to keep detailed records in place – both for all affiliates and the holding company – and report the "financial condition, policies, systems for monitoring and controlling financial and operational risks, and transactions and relationships between any broker or dealer affiliate of the supervised investment bank holding company" (ibid). This included independently audited financials – balance sheet, cash flow statement and income statement – for the holding company. Crucially, it also gave the SEC examination authority over the holding company (in addition to any affiliate) which had to inform the Commission about the holding company's financial and operational risks as well as the risk management systems in place.

The SEC adopted an amended Supervised Investment Bank Holding Company regime on the 20th of August 2004. The main changes to the existing rules focussed on bringing the SIBC more in line with the risk management, reporting and capital adequacy requirements as set out in the Basel standards (especially what would later become Basel II). However, whilst introducing Value at Risk models and Basel type methodologies into the SEC capital and liquidity requirements, the Commission did not allow for an explicit capital relief as was the case in the CSE programme. Unsurprisingly, the industry favoured the CSE programme and not the SIBHC regime. During the entire public consultation process on the proposed amendments to the SIBHC regime, the Commission received in total only two comment letters from the industry: one from the International Swaps and Derivatives Dealers Association (ISDA) and one from Bear Stearns Companies, Inc. Both letters provided comments on the proposed holding company credit and operational risk requirements only. The vast amount of intended rules changes received no industry feedback reflecting the industry's lack of interest in the voluntary SIBHC regime. Even though the regime had been in place since 1999, only one investment bank ever elected to be supervised in this way: more than eight years after the passage of Gramm Leach Bliley, Lazard

Ltd. became a Supervised Investment Bank Holding Company on April 1st, 2008. In the following, the chapter traces back the reasons for enacting the CSE programme since the SIBHC already offered a voluntary, consolidated supervision regime.

8.3 THE EUROPEAN FINANCIAL SERVICES ACTION PLAN AND ITS IMPACT ON US INVESTMENT BANKS

8.3.1 The Making of an Integrated EU Market in Financial Services

Starting in the 1970s, the European Court of Justice (ECJ) decided on a series of cases brought against national governments by companies that aimed at reducing the burden to comply with a set of overlapping, incompatible as well as additional home and host state standards in relation to the cross-border trade in goods and services. The harmonisation and/or mutual recognition of standards and reduction in technical barriers to trade amongst European Community (EC) member states became one of the core initiatives of the European Commission with the aim to achieve this in many areas by 1992.

Looking at the financial services sector, the EC and its member states adopted several directives, such as the Public Offers Directive and the Investment Services Directive (ISD) (The Council of the European Communities 1993), in order to harmonise the regulatory regimes at the national level and work towards building a single internal market. In 1993, the ISD established what would later become known as the 'EU Passport' in financial services, namely an

> approach adopted [is] to effect only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems, making possible the grant of a single authorization valid throughout the Community and the application of the principle of home Member State supervision; whereas, by virtue of mutual recognition, investment firms authorized in their home Member States may carry on any or all

> of the services covered by this Directive for which they have received authorization throughout the Community by establishing branches or under the freedom to provide services (ibid).

The ISD prescribed minimum standards for the passport regime, i.e. the ‘necessary’ and ‘sufficient’, which still allowed for enough room in structural differences and diversity between countries’ regulatory regimes. With the transfer and pooling of certain aspects of member states’ sovereignty to the EC legislature and Commission, the Commission was authorised to monitor member states’ implementation of and compliance with EC Treaties and Directives. In case of non-compliance, it could start enforcement proceedings in front of the ECJ, whose rulings on these and other matters gradually built up a corpus of case law that superseded national laws. Despite the ISD’s intentions and the EC’s institutional underpinnings, many financial services companies grew frustrated with the implementation efforts on a national level, especially with the mutual recognition system. As a result, the Commission kick-started the Financial Services Action Plan (FSAP) in 1999, its most comprehensive programme to date with the goal of creating a common EC market in financial services. To this end, the Economic and Finance Council (ECOFIN) of the EU created the ‘Committee of Wise Men on the Regulation of European Securities Markets’ under the chairmanship of Alexandre Lamfalussy in July 2000, commonly referred to as the ‘Lamfalussy Process’. The committee’s mandate was threefold, namely: first, to assess the current conditions for implementation of the regulation of the securities markets in the EU; second, to examine how the mechanisms for regulating these markets can best respond to current market developments; third, to come up with proposal of how to eliminate barriers and achieve greater convergence and cooperation in day-to-day implementation.

The final report was published in February 2001 and made recommendations on twenty-one subject areas (The Committee of Wise Men on the Regulation of European Securities Markets 2001)**.** The Lamfalussy Committee was in broad agreement that the current EU financial regulatory framework was “too slow, too rigid, complex and ill-adapted to the pace of the global financial market change”, that the institutional set-up of the EU creates “multiple blockages” and ambiguities and that the EU "has no divine right to the benefits of an integrated financial market", but has to build one in order to reap the benefits, deepen European integration and strengthen the Euro's role (ibid, p.7)**.** Without going into great detail about all the specific subject area recommendations and the four-level implementation approach, the Committee prioritised the following key elements of the FSAP and urged for its adoption by the end of 2003 at the latest: a single prospectus for issuers, modernisation of listing requirements, home country regulation of all wholesale market participants and a definition of an professional investor, adoption of international accounting standards, a single passport regime for recognised stock markets and a modernisation of investment rules for investment and pension funds.

The Lamfalussy report was a wake-up call for EU decision-makers and provided the necessary impetus to push to what amounted essentially in an overhaul of the EU's regulatory framework for financial services creating an internal common market. To this end, the European Commission adopted

1. The Market Abuse Directive in 2002;
2. The Prospectus Directive in 2003;
3. The Market in Financial Instruments Directive and the
4. Transparency Directive in 2004.

Academics see the reasons behind this journey from half-baked harmonisation efforts to building a coherent common market in the rise of technological advancements and a rapid increase in cross-border financial activity, US competition and the creation of the Euro together with an enlargement of the EU (Mügge 2006).

Whilst not being part of Lamfalussy Report, the FSAP called for prudential supervision of financial conglomerates. With the momentum and energy that Lamfalussy created, the Commission started a public consultation process in December 2000, and proposed a new directive in April 2001 that would seek group-wide supervision of financial conglomerates (European Commission Internal Market Directorate General 2000)**.** The proposal's main objectives were: firstly, ensure that conglomerates have adequate capital at the conglomerate level and avoid double counting of capital and regulatory arbitrage; secondly, calculate a proposal for an overall solvency position, and lastly, ensure proper risk management. Areas of 'underlaps' and 'overlaps' in regulating financial conglomerates needed addressing in order to eliminate inconsistencies and ensure equivalence in the treatment of conglomerates. The proposal sought information sharing and cooperation between different supervisory authorities at the national level as well as equivalence of treatment between the EU and non-EU financial regimes.

Subsequently, the Mixed Technical Group on the Prudential Regulation of Financial Conglomerates ran two mapping exercises in order to better define what a financial conglomerate is, and subsequently, which financial services groups would fall under the proposed consolidated supervision. The proposal put forward various ranges and tests in order to identify which groups would fall under the category of being a financial conglomerate (such as, the size of the balances sheet of the smallest financial activity within a group exceeds €6bn). Above all, the Mixed Technical Group was keen to ensure that its "mapping exercises" captured all important financial conglomerates within the EU.

8.3.2 The Crux of the Matter for US Investment Banks

The Financial Conglomerates Directive was enacted in December 2002 and prescribed that a 'coordinator', i.e. a competent regulator, had to be appointed to be charge of the consolidated supervision of the financial conglomerate as a whole (The European Parliament and the Council of the European Union 2003). If the financial conglomerate had its parent holding company within the EU, then this coordinator was typically picked from among the host regulator(s), such as the EU regulator in the country where the financial conglomerate has the largest balance sheet total. In case conglomerates have more than one regulator, the country home to the conglomerate's largest balance sheet in the most important financial sector would become the 'coordinator'. The 'coordinator' became effectively the lead conglomerate's lead regulator: it became responsible for collating key information from the conglomerate, assess its financial situation, compliance with capital adequacy rules, risk concentration and intra-group transactions, assessing the financial conglomerate's structure, governance and risk management and taking the lead in case of emergency situations. The Directive also set out clear powers and guidelines for the 'coordinating regulator' to have coordination and information sharing arrangements with other EU regulators in place:

> without prejudice to their respective responsibilities as defined under sectoral rules, these authorities, whether or not established in the same Member State, shall provide one another with any information which is essential or relevant for the exercise of the other authorities' supervisory tasks under the sectoral rules and this Directive (ibid).

Despite the SIBHC regime, not a single US investment bank opted to be voluntarily subjected to consolidated SEC supervision. However, the EU's Financial Conglomerates Directive was about to drastically change the regulation of investment banks in the US. The Directive applied to any financial services company falling under the definition of a financial conglomerate that was active in the European Union, irrespective of the geographical location of the conglomerate's parent company and host regulator. In other words, the Directive established a mandatory regime of consolidated financial supervision in the EU. Importantly, for 'parent undertakings' outside the EU, the supervisory regime of non-EU countries had to be equivalent to that of the Directive with "appropriate supervisory arrangements" so as to achieve objectives and results similar to those pursued by the Directive. However,

> equivalent and appropriate supplementary supervisory arrangements can only be assumed to exist if the third-country supervisory authorities have agreed to cooperate with the competent authorities concerned on the means and objectives of exercising supplementary supervision of the regulated entities of a financial conglomerate (ibid).

It was up to the EU's regulators at the national level which would otherwise have qualified as 'coordinators' to determine whether or not the third-country regulatory regime could be deemed equivalent so as to avoid third-country financial conglomerates being subject to consolidated financial regulation (including capital adequacy) in the EU as well as their home market. Given the size and the importance of the City of London, the UK's financial industry, in the EU, the UK Financial Services Authority (FSA) would clearly take the lead role in conducting the equivalence assessments. The EU's Banking Advisory Committee (BAC) issued general guidance in 2004 with respect to the equivalence of the US financial regulatory regimes to the EU Directive. Whilst this guidance was of a general nature, the EU Directive made it mandatory to take it into account for the coordinators assessing the equivalence. The BAC gave a short commentary on each of the US's functional regulators; with respect to capital markets supervision, it noted that "the SEC has not, to date, undertaken comprehensive consolidated supervision, but is soon to introduce two new regimes that will enable the larger US broker-dealer groups to opt for consolidated supervision" (The European Financial Conglomerates Committee to EU supervisors 2004). The BAC guidance stated that the SEC supervision until the enactment of the EU Financial Conglomerates Directive did **not** qualify as offering an equivalent standard, but that this was about to change, in large part driven by this Directive.

8.4 THE UNFOLDING OF THE SEC RESPONSE

In May 2002, the Director of the SEC's powerful Division of Market Regulation (to be renamed Division of Trading and Markets in 2007) Annette Nazareth, testified before the Committee on Financial Services of the US House of Representatives on 'Certain Pending Proposals by the European Commission' (Annette Nazareth 2002). Ms. Nazareth explained the connection between the EU's FSAP and the Financial Conglomerates Directive, which would set minimum requirements for groupwide supervision of financial conglomerates active in the EU. She stressed that "several U.S. securities firms have communicated to the Commission that they have serious concerns with the Proposed Directive" and "fear" that the SEC's supervision of investment banks at the holding company level would not be seen as equivalent to the EU's standards, thereby putting them at a competitive disadvantage to EU based firms, and potentially subjecting them to higher capital and risk control standards than EU firms (ibid). US investment banks might have to establish and capitalise EU sub-holding companies.

She emphasised that whilst the SEC welcomed the EU's push as an effort to harmonise regulatory regimes, "to the extent 'equivalence' is really a means of having a 'coordinator' in the EU evaluate the quality of our regulatory regimes, we do not think that approach will be productive or add to investor protection" (ibid). Nazareth alluded to a supervisory over-reach by the EU whilst agreeing that effective supervision is important for well-functioning capital markets, of which the US ones "are the largest and most successful in the world" (ibid). According to Nazareth, the SEC had "productive discussions" with EC representatives, including the issue of equivalence, and "firmly" believed that the SEC's "approach to the supervision of securities firms is as effective as that in the Proposed Directive" (ibid). She went on to highlight "the remarkable success" of the Commission's regulatory regime which had ensured the maximum level of financial integrity and investor protection with very few investment banks failing, but in case of failure (as with the then defunct investment bank Drexel Lambert), the investment bank was liquidated in an orderly fashion without any government capital injections or a negative impact on markets (ibid).

During the same hearing session of the House Committee, Mr. Marc Lackritz, the President of the Securities Industry Association – the US investment banking's lead industry association – also testified. He urged for the US Executive as well as Legislative to get more involved since the FSAP would create one single, integrated capital market by 2005 (Marc Lackritz 2002). The SIA "strongly supports" the FSAP and the Lamfalussy Report, had worked closely with EU actors at both national and EU level, and saw the FSAP as being "in the best interests of the EU, the US, and the global economy"; indeed, the US securities industry would be "one of the primary beneficiaries of a more integrated, efficient EU capital market" (ibid). Lackritz stressed that "the US-EU relationship relies on common social and political goals and the exchange of ideas, talent and technology" (ibid). However, the SIA had "strong reservations" about certain provisions within the EU Financial Conglomerate's Directive related to third-country supervision of financial conglomerates operating in the EU, but with headquarters outside the EU. In Lackritz's words, these provisions were "inappropriate and should be removed", the SIA would be "specifically troubled" by national EU regulators (i.e. the 'coordinators') undertaking equivalence determinations and failing to meet the equivalence criterion would force US investment banks to establish EU holding companies (ibid). Instead of running equivalence tests, regulators should coordinate their actions more flexibly by way of regular meetings.

It is important to note that, as mentioned earlier, the Financial Conglomerates Directives was one of many proposed directives that were part of the FSAP and Lamfalussy plan to create a common EU market in financial services. At the beginning of the proposal process for the EU's Financial Conglomerates Directive, the SEC derived the merits of its regulatory regime for investment banking on the 'remarkably successful' track record of US capital markets and investment banking performance since the 1970s, and equates this success with having established an effective regime of SEC regulation that ought to be equivalent to the proposed EU Directive. The US investment banking industry's initial position via-a-vis the Directive was one of opposition: it feared that national, 'coordinating' regulators could be inconsistent and arbitrary in their equivalence assessments and that they might have to create EU holding companies in addition to their US parents. In other words, the Directive would decrease the attractiveness of doing business in the EU for US investment banks. Moreover, the proposed EU regulatory regime would certainly not entice US investment banks to move their parent headquarters from the US to the EU.

Things progressed swiftly in Europe; the European Council and Commission came to a common position on the adoption of the Financial Conglomerates Directive on September 20th, 2002 – only four months after Nazareth's and Lackritz's testimonies. Exactly two months later, the European Parliament adopted the Directive on November 20th, 2002. Surprisingly, no other hearings that focussed on or at least were in large part about the EU's Financial Conglomerates Directive were held for the remainder of 2002 or the whole of 2003, in front of either the Senate or the House of Representatives. Indeed, the SEC provided no additional public information or statements in relation to the Directive – neither as an organisation nor through one of its officers – until October 1st, 2003, when it published its agenda for an open meeting on October 8th. During this open meeting, the SEC would discuss "whether to propose rule amendments and new rules under the Securities Exchange Act of 1934 that would establish two separate voluntary regulatory frameworks for the Commission to supervise broker-dealers and their affiliates on a consolidated basis" (SEC 2003). In this publication, the SEC introduced the concept of a 'consolidated supervised entity (CSE), and explicitly linked the consolidated supervision with capital computations that would be consistent with the Basel standard. In 2002 and 2003, the SEC held various meetings with its European counterparts during which EU officials indicated that the EU would go ahead with the Financial Conglomerates Directive, that the Directive would apply to any financial conglomerate conducting business in the EU and that the SEC regulation of US investment banking, including its voluntary SIBC regime, "would likely fail the EU's equivalence test" (AN 2011). The SEC had thus been working on a proposal to create a regulatory framework that would meet the equivalence test of the EU.

8.4.1 The UK's FSA Response of US Investment Banking 'Shopping Around'

Whilst the SEC was going full speed in drafting proposed rules that would meet the EU's standard of equivalence, the FSA – the European regulator most likely to become the most relevant and sought-after European coordinating regulator for third party conglomerates – issued a consultation in October 2003 (UK Financial Services Authority 2003). In the consultation, the FSA argued that

> we believe it is unlikely to be possible in practice for us to implement full worldwide group supervision of third country conglomerate or banking/investment groups from the UK [which fail the equivalence test], and we shall rely on other methods. This may well require the establishment of a European holding company and restriction of exposures between the European sub-group and the worldwide group ('ring-fencing') (ibid).

The UK's FSA thus made it clear that investment banks with home regulators whose country's regulatory regime failed the equivalence tests could not simply move its legal headquarters to the UK, but would have to establish a separate European holding company instead. Indeed, some US investment banks toyed with the idea of moving their legal headquarters, i.e. the place of jurisdiction of their ultimate parent holding companies, from the US to the UK. As a senior UK financial regulator recalls, "one or two of the investment banks did say, well maybe we actually move from the US to the UK" as this could avoid them having to establish a holding company in the Europe which would tie up a lot of capital in addition to the SEC broker dealer (DH 2010). Their rationale was that they might be better off "being prudentially supervised in Europe completely, and that would be simpler and a more effective use of capital and they told us that they could then trade back in the US where they would not have to be under consolidated supervision" (ibid). As another top UK regulator pointed out "it was not part of our design to entice business out of NYC to London - full stop - we had different approaches and different historical traditions" (McC 2011). In the end, and as the FSA's public consultation paper reflected, senior ranks of the FSA "did not give them any encouragement in moving their HQs" (DH 2010).

8.4.2 The SEC's Proposed and Final Rules

On October 24th, 2003, the SEC published the proposed rules 'Supervised Investment Bank Holding Companies' (SIBHC) as well as 'Alternative Net Capital Requirements for Broker-Dealers that are part of Consolidated Supervised Entities', which set out in great detail, as already discussed earlier in the chapter, the CSE programme as well as the alternative net capital requirements (SEC 2003). The CSE programme would "minimise duplicative regulatory burdens" for US investment banks active in the EU whilst the alternative net capital requirements would bring the net capital rule more in line with Basel capital standards (ibid). This would give the SEC "a useful measure of the CSE's financial position and allow for greater comparability of the CSE's financial position to that of international securities firms and banking institutions" (ibid). Comments for both proposed rules were due on February4th, 2004.

On the 18th of December 2003, the SEC met with the SIA and representatives from essentially all major investment banks (Bear Stearns, Citi, Merrill Lynch, JP Morgan, Goldman Sachs, CSFB, Lehman Brothers, UBS and Morgan Stanley) to discuss the proposed rules (SEC 2004). Representatives of the Commission met separately with Merrill Lynch one day later. The CEO and CFO of Bear Stearns met with Annette Nazareth, the Director of the SEC's Division of Market Regulation – the division in charge of drafting the proposed rules and coordinating the process – on

March 10th, 2004. Both meetings were the only bilateral encounters between US investment banks and the SEC during the comment period.

The SEC received, in total, 20 comments on the proposed alternative net capital rule and the CSE programme: two from private persons (Mr. W. Hardy Callcott andMr. Leonhard D. Bole), seven from industry associations (CSE Steering Committee, Association of German Public Sector Banks, Clearing House Association, International Swaps and Derivatives Association, American Bankers Association, Institute of International Bankers, European Banking Federation), one from a US regulator (Office of Thrift Supervision) and ten from banks as well as investment banks (Bear Stearns, Lehman Brothers, Charles Schwab, Morgan Stanley, Deutsche Bank, Citigroup, JP Morgan, Goldman Sachs, Merrill Lynch and BMO Financial). The tenor of the investment banks' feedback focussed on three areas: first, EU equivalence determination and timely implementation of CSE, second, adoption of Basel capital standard-esque regulation for CSE investment banks and third, VaR models.

On the issue of equivalence and CSE implementation, the general counsel of Lehman Brothers, Joseph Polizzotto, stressed that "it is of critical importance that the Commission implement the Proposing Release in such a way that the CSE Rules are deemed to be equivalent" (Lehman Brothers 2004)**.** Goldman's CFO David Viniar urged the SEC to adopt the CSE rules asap "to permit the CSEs to implement them for financial years commencing on or after January 1st, 2005" (Goldman Sachs 2004)**.**

Morgan Stanley's CFO, Stephen Crawford, along with other investment banks, voiced the importance of harmonising risk management and capital computation standards across the entire CSE – i.e. not just the broker dealer, but also the holding company – to establish a regulatory regime that captures how investment banks actually manage their risks and capitalise their business and, finally, to promote greater consistency with Basel II. Such a regime "must be consistent with the related supervisory standards that are applicable to financial institutions across international markets" (Morgan Stanley 2004)**.**

Finally, all investment banks provided in-depth technical comments on the alternative net capital rule: all rejected a product-based phasing in of VaR models, disagreed with the risk weights on the trading book, which were deemed too high and thus capital intensive, and allowed investment banks to count long-term debt as capital.

Comments received from commercial banks and bank holding companies voiced two concerns: first, being subject to and paying for a multitude of overlapping consolidated regulatory regimes, i.e. both the CSE and the Fed's BHC, and second, being able to apply the same consistent capital standard and computation for the CSE as is already the case for the Federal Reserve or other banking regulators, i.e. the Basel standard. As John Morris, Citigroup Global Market's CFO, commented, "the Proposal should be revised […] to not become subject to a new layer of comprehensive consolidated supervision in addition to that already exercised by the Fed" (Citigroup 2004). Deutsche Bank's General Counsel Richard Walker put it more bluntly "the proposed rule would conflict […] and would subject bank holding companies and foreign banks to an unfairly burdensome system of overlapping consolidated supervision" (Deutsche Bank 2004). The issue of regulatory overlap was a concern voiced by the American Bankers Association as well as the New York Clearing House Association - both industry groups representing Bank Holding Companies and shared by the Office of Thrift Supervision (OTS) which commented that the CSE programme had "the potential to duplicate or conflict with OTS's supervisory responsibilities for Savings and Loan Holding Companies (SLHCs) that would also be CSEs" (Office of Thrift Supervision 2004). The OTS's comments carry a certain irony, as it was lobbying at the time to become the investment banks' consolidated regulator in the US, since the "Federal Reserve was regarded as the regulator from hell for investment banks because of extremely hands-on approach" (SB 2010). However, the OTS bid to become the consolidated regulator was shut down by the US Treasury Secretary. As a senior regulator from the UK recalls, "when I heard about the OTS's bid, I asked for a call with the US Treasury Secretary: 'is this serious?' To which he responded 'Oh God it is not. We don't want that. We know it is mad and will shut it down'" (DH 2010). The OTS was widely seen in the regulatory community and amongst investment banks as "buffoons who did not know which way the sun rose" (CR 2010).

Industry associations representing non-US financial services groups, such as the European Banking Federation, the Association of German Public Sector Banks and the Institute of International Bankers were – ironically – worried that the proposed rule would take away control from non-US banks' home country regulators that already provide consolidated supervision. They, too, emphasised that non-US regulated investment banks should be able to follow "home country Basel capital methodologies" (FEDERATION BANCAIRE DE L'UNION EUROPEENNE 2004). All three associations worked together closely on this matter and coordinated their responses, which is reflected in the often near-identical wording of their comment letters.

The SIA's very detailed comment letter emphasised that the CSE programme "fully meets the equivalence" standard in their opinion, that it provided economic incentives via lower capital charges, but required more rigorous, Basel type risk management and exposure modelling in return (Securities Industry Association 2004). The association welcomed the alternative net capital rule's closer alignment to the Basel international capital standards, which it believed would support the competitiveness of US investment banks. It urged the SEC to play an active role in the "ongoing development of international standards for risk management and capital adequacy", which accounts for the particularities of the investment banking business. In line with all the comments discussed before, the SIA argued for close and consistent alignment between broker dealer, holding company and Basel capital (ibid).

Meanwhile, in July 2004, the EU's Financial Conglomerates Committee issued general guidance to EU supervisors on the extent to which the financial regulatory regimes in the USA would meet the equivalence standards as set out in the Directive (European Financial Conglomerates Committee 2004). It states "the SEC has not, to date, undertaken comprehensive consolidated supervision but is soon to introduce two new regimes that will enable the larger US broker-dealer groups to opt for consolidated supervision" (ibid). Whilst equivalence decisions had to be taken by the 'coordinating regulators', this statement was tantamount to the SEC CSE programme fulfilling the EU's consolidated supervisory standards – and indeed, this was subsequently confirmed.

The SEC issued the final rule for both the CSE programme and the SIBHC on August 20th, 2004 (SEC 2004). Immediately afterwards, all of the big US investment banks elected to be supervised voluntarily as part of the CSE programme. Merrill Lynch & Co., Inc. was the first to have its 'election' to be supervised as a CSE granted on December 23rd, 2004. Goldman Sachs & Co followed on March 23rd, 2005, Morgan Stanley & Co on July 28th, 2005, Lehman Brothers Holdings Inc. on November 9th, 2005 and the Bear Stearns Companies Inc. was the last one on November 30th, 2005.

A side note on investment banks' leverage and the net capital rule

As the literature review demonstrated, many scholars claimed that the SEC change to the net capital rule allowed investment banks to increase their leverage (Helleiner 2011), with some scholars claiming that investment banks tripled their leverage (Reinhart and Rogoff 2009). As Erik Sirri, the SEC's Director of the Division of Trading and Market pointed out during a speech at the National Economists Club about Securities Markets and Regulatory Reform, "the Commission did not eliminate or relax any requirements at the holding company level because previously there had been no requirements" (Erik Sirri 2009). He argued that

> The net capital rule requires a broker-dealer to undertake two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the actual amount of net capital held by the broker-dealer. The "12-to-1" restriction is part of the first computation and it was not changed by the 2004 amendments. The greatest changes effected by the 2004 amendments were to the second computation of actual net capital (ibid).

As a joint research paper from Tobias Adrian of the New York Fed and Hyun Song Shin of Princeton university shows, investment banks' average leverage was actually higher at several times during 1995 and the year 2000 than during the crisis in 2008 (Adrian and Shin 2010). This, taken together with the correct technical explanations of what the alternative net capital rule actually changed in conjunction with the old rule (as set out by Sirri), negates the conventional wisdom in the media and academia that leverage reached (1) unprecedented levels in investment banks and that (2) this was driven by the SEC’s consolidated supervised entity programme.

8.5 A POLITICAL ECONOMY ANALYSIS

Contrary to some academics’ arguments, such as “investment banks supported and lobbied the US authorities first to remove Glass Steagall in 1999, move to new SEC rules in 2004” (Blundell-Wignall, Atkinson et al. 2008), or that the SEC “agreed to a request by the five large investment banks to use their own internal models, based on historical data to calculate “net capital” in their broker-dealer operations” (Johnson and Kwak 2010, p.140), it was not the US investment banking community that lobbied for the SEC’s CSE programme. As the case study showed, far from a Wall Street Treasury Complex pushing for the CSE Programme, it was the European process of creating a single, integrated market for capital and financial services in the EU that started the ball rolling. The European Union’s Financial Services Action Plan from 1999 set out an ambitious timetable which, thanks to the Lamfalussy Report, received enough impetus to bring it to fruition by 2005. The EU Financial Conglomerates Directive was enacted in 2002 (but needed EU national level ratification on a country by country basis), which put enormous pressure on US investment banks either to establish a separately capitalised EU holding company, move their headquarters across or lobby the US government and regulators to find a solution. The first option was not attractive to US investment banks, as they would have to employ more capital and deal with additional regulatory complexity. The second option – moving their parent holding companies from the US to the EU – would have been “political suicide as Wall Street’s investment banks were seen as American and I am sure the Bush administration made it very clear that they would not accept them moving to Europe just to save a few bucks in capital” (DJ 2010). In addition, as the author’s elite interviews show, the top officials of the United Kingdom’s Financial Services Authority did not lobby for it, but discouraged it. Nevertheless, some US investment banks did consider moving their parent company across, but were rebuffed by the Financial Services Authority. This left US investment banks having to find a regulatory solution within the US.

Lacking the statutory authority to do so, the SEC had already offered a voluntary regime for consolidated supervision as part of the Gramm Leach Bliley Act, the so-called Supervised Investment Bank Holding Company (SIBHC) regime. However, no investment bank had signed up for SIBHC status, and the regime itself did not fulfil all of the EU's criteria in order to be deemed equivalent. The SEC therefore had to act as well.

Looking at it through the lens of the statutory authority hypothesis, the SEC was confronted to react to a regulatory request from abroad and – if it did not want to risk its regulatory regime being deemed as non-equivalent – was forced to respond. Even more troubling was the fact that its statutory authority was not only impacted by international, external factors beyond its reach, but it also lacked the statutory authority domestically to make the CSE programme obligatory. The Commission was thus left with two options: hope that Congress would pass new legislation that would give the SEC statutory authority time to enact a regime of consolidated supervision for investment banks; or to act itself and create a voluntary supervisory regime. The SEC did the latter and its CSE programme remained voluntary until its closure in 2008. However, apart from the CSE programme being challenged in the courts (which it could have, but was not), the SEC was able to bring about significant regulatory change without legislative change. The SEC lacked statutory authority, but had the backing of the investment banking community, meaning that in terms of ideational support, it was aligned with the industry and regulators on both sides of the Atlantic. Moreover, the SEC could offer investment banks a 'safe harbour'. As the US House Committee testimonies from 2002 reflect, the US investment banking industry was very sceptical about the EU's Financial Conglomerates Directive. They feared that investment banks could be held to ransom as a result of unclear and non-standardised equivalence tests being conducted by EU supervisors.

The broad ideational consensus amongst investment banks and policymakers on both sides of the Atlantic was also reflected in the SEC's alternative net capital rule and its incorporation of 'state of the art' risk modelling and management methods. By allowing investment banks to use internal risk models applying VaRs, the SEC was aware that this would lower the deductions for market and credit risk, but there was the belief that the internal risk management system the CSE Programme would be ‘robust’. Moreover, the SEC sought to align its net capital rule with Basel standards, which were seen as “the holy grail of risk management at the time” (CR 2010). Applying the role of ideas hypothesis, the SEC clearly believed that a reduction in capital was acceptable because of the belief in the mathematical models and modern risk management techniques. This was because the concept that regulation by regulators and not markets was becoming

> increasingly unacceptable, so much so that our Division of Market Regulation opted for changing its name to the Division of Trading and Markets as otherwise you would be on the defence as soon as you walked into House and Senate Hearings (AN 2011).

The SEC “subscribed to the free market consensus with the CSE programme, too; however to be on the safe side, we included the $5bn capital notification requirements into the programme just so that we have ‘plug’ as we had very little experience with VaR models and Basel” (CR 2010).

As can be seen from the various comments received on the proposed CSE rule and the meetings held, the industry fulfilled once more a crucial role in providing expert, highly technical information to the SEC. Both hypotheses can easily be tested here. The comments during the consultation period reflect a degree of technical feedback, which the SEC not only took very seriously in its consideration for drafting the final rule, but also relied on in part. As the thesis has shown throughout the various case studies, the provision of expert information to regulators can be classified as industry influence. However, the feedback – both from investment banks as well as from non-investment banks – was simply driven by the fact of how the proposed rule could create unintentional, negative consequences, of which the Commission might not have been aware. In fact,

> even with the largest team of SEC lawyers, the complexities involved in drafting the alternative net capital rule were enormous and we were grateful for the industry feedback since despite our hardest work, we overlooked certain issues which the comments subsequently pointed out and helped rectify (MP 2010).

Finally and once more, the hypothesis that a revolving door between SEC and the industry could in some form influence regulatory decision-making is not applicable, as the impetus for this episode of deregulation emanated from Europe and its political will of closer integration.

On September 26th, 2008, the then Chairman of the SEC, Mr. Christopher Cox, announced the end of the CSE programme. There were no investment banks left that were legally incorporated as CSEs. Five days prior, on the 21st of September 2008, both GS and MS received approval from the Federal Reserve to switch their legal entity from an investment bank to Federal Reserve regulated Bank Holding Companies. Eleven days earlier, Lehman Brothers Holding Inc. (LBHI) had filed for Chapter 11 bankruptcy protection in New York. The Bear Stearns Holding Company Inc. (TBSCI) entered into a merger agreement with J.P. Morgan Chase & Co (JPM) on the 16th of March 2008, in which JPM rescued the faltering TBSCI with the support of the US Treasury and the Federal Reserve.

The events between the establishment of the CSE programme and its demise are so complex that they are outside the scope of this case study.

Hans Trees,
SGIA, Durham University

CHAPTER 9

CONCLUSIONS

9.1 INTRODUCTION

The research project that is this dissertation started with the author's astonishment at academics' and the media's statements about the alleged power and secret influence that an ill-defined entity called Wall Street was said to have vis-à-vis its regulators, key policymakers and commercials banks. Whilst still working in investment banking, but already developing this thesis's research proposal, the author was perplexed about the lack of empirical backup for some of the key texts about investment banking in the IPE of finance[1]. Even more surprising was the fact that despite the importance and power attached to Wall Street and investment banking, there was no distinct body of work in the IPE specifically researching this area of finance.

The thesis demonstrated that investment banks are very different legal entities, as well as businesses, from commercial banks. Investment banks are neither deposit-taking nor engaged in maturity transformation. They are (were) regulated by distinct regulators, i.e. the Securities and Exchange Commission, and not the Federal Reserve (at least not until the breakdown of Wall Street in 2008), and governed by rules that are tailored to investment banks' needs – and more specifically tailored to protect investors, not investment banks. These rules are, again, very different from those of commercial banks. As the case studies highlighted, the Federal Reserve focuses on commercial banks' solvency, which is intimately tied up with their profitability. In other words, losses suffered by commercial banks will eat into banks' equity, lower their capital ratios and force them either to scale back their balance sheets, i.e. to de-lever, thereby reducing the money supply to the economy, or to raise fresh capital. By contrast, investment banks do not supply an economy with money, as their balance sheets are marked to market and they do not create money with their clients' deposits.

[1] As the literature review highlighted, the current scholarship in the IPE of investment banking has many empirical gaps. During the author's initial literature search to develop the research proposal, he was particularly taken aback about the sweeping claims made by Underhill and Zhang (Underhill & Zhang, 2008) and Jagdish Bhagwati (Bhagwati, 1998) without providing substantial empirical backup.

The overwhelming majority of newspaper and academic pieces did not capture the complexities of these very different business models and underlying regulatory regimes for investment and commercial banking. The literature review has laid out the various gaps in the scholarship on the IPE of investment banking. The majority of works claiming to analyse the IPE of investment banking base their arguments on hearsay and/or are self-referencing. In particular, claims made about the lobby power of Wall Street in achieving de-regulatory outcomes, such as the repeal of Glass Steagall and the SEC's Consolidated Supervised Entity Programme, are being presented without empirical backup and with authors mixing up commercial banks and investment banks.[2]

Why does this matter?

Failing to appreciate the differences between commercial and investment banks leads to inaccurate academic research, can skew public and politicians' opinions (as was and still is the case about who was lobbying to repeal Glass Steagall) and can ultimately result in sub-optimal regulatory outcomes for investment banks and societies at large if legislators follow incorrect guidance. The financial crisis of 2008 (and beyond) is a good case in point. When the financial crisis hit in 2008, it was not the failure of Lehman Brothers or the fire-sale of Bear Stearns that brought the US and world economy terrifyingly close to collapse. Whilst a detailed analysis of this crisis could fill the space of many PhD theses to come, it is important to note that Bear Stearns was highly liquid weeks before its arranged sale to JPMorgan. In the words of the then SEC Chairman, Christopher Cox

> the fate of Bear Stearns was the result of a lack of confidence, not a lack of capital […] specifically, even at the time of its sale on Sunday, Bear Stearns' capital, and its broker-dealers' capital, exceeded supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity – not inadequate capital – caused Bear's demise (SEC 2008).

2 See for example, works by Baker (Baker, 2010) or (Reinhart & Rogoff, 2009).

The key word in Cox's statement is confidence. Because of a lack of confidence, Bear Stearns had to start selling off its balance sheet assets at prices below book, which then caused an avalanche in the world's financial markets as these new, lower prices forced all other market participants to mark their books to these new market prices. In a way, a lack of trust combined with full market transparency on asset pricing set off a downward spiral. The ones caught in the middle of all this, and with massive exposures to assets with rapidly declining prices, were the world's commercial banks (i.e. US commercial banks, Japanese commercial banks, all German commercial banks, all UK commercial banks, many German, Spanish and Italian savings banks; the list could go on). A deterioration of asset prices forces investment banks to unwind their positions in order to remain liquid, but it destroys commercial banks' balance sheets and solvency position causing them to become insolvent, i.e. bankrupt. Ironically, then, it was the UBSs, the Credit Suisses, the RBSs, the Commerzbanks and the Unicredits of the world that had to be rescued or bailed out; not because of failings in their core commercial or retail banking business (even though the amount of non-performing loans started to rise), but because of their involvement in investment banking activities, and worse, as a result of them buying investment banking investment products either on their own account or with their clients' money. In all instances, the financial crisis of 2007 devastated commercial or European style "universal" banks in much the same way: losses as a result of holding or selling positions whose value had to be marked down significantly, ate into banks' core equity capital forcing them to de-lever rapidly or requiring government bail-outs For example, UBS was still increasing its presence in sub-prime mortgage backed securities at a time when Goldman Sachs had largely exited this market in 2007. UBS alone suffered the largest loss ever recorded in Swiss corporate history in 2008.

One could easily blame the financial crisis of 2008 on Wall Street, on the repeal of Glass Steagall or on the SEC's net capital rule change in 2004; and a number of journalists and academics did exactly that. However, when scratching the surface, the thesis has shown that the causes behind the repeal of Glass Steagall and the SEC's CSE Programme are to be found in very different corners, which are sometimes unrelated, and sometimes diametrically opposed to Wall Street and its interests. In other words, in examining the political economy of the financial regulation of US investment banking, this thesis provides a timely and important contribution to better understanding the paths and unintended consequences of regulatory decision-making in finance generally, the role of the judiciary in this process, the importance of regulators' statutory authority, the impact of an ideational consensus and the role of lobbying. In doing so, the thesis unpacked all these complexities and lined them up in logical order so that readers and researchers can identify the thread that, for example, connects US Court rulings in the 1960s to the Gramm Leach Bliley Act of 1999.

The dissertation set out to uncover the political economy of financial regulation of US investment banking. In particular, it sought to understand the factors behind complex episodes of de-regulation, and examine how these link up to the claims made about Wall Street in academia and the media.

Given the absence of an established research programme in the IPE of investment banking, the thesis is a stepping-stone for other academics to build on and deepen our understanding about the political economy of investment banking: its actors, policy positions and regulators. The research puzzle was thus to uncover the political economy of financial regulation of US investment banking. The thesis picked its cases on the dependent variable, i.e. a key deregulatory event or reduction in regulation. The dissertation applied the qualitative research design of the case study method: a reduction in regulation can refer to a lessening in regulatory capital standards, less stringent reporting requirements or greater access to hitherto restricted financial markets. As the five case studies have shown, the process-tracing exercise was crucial in identifying and examining the complex chains of causalities that ultimately ended in a reduction in regulation. Nearly forty non-attributable interviews with the elites from finance, regulation and law were key in connecting the dots and understanding actors' preferences.

Ultimately, the dissertation's findings and case studies have wider applicability for scholars of international political economy: the role of the courts and regulators' statutory authority are just two aspects (or explanatory variables) that political economists and political scientists have not paid sufficient attention to, and which should feature more prominently in future research.

9.2 HYPOTHESES

Interest group based hypotheses

At the beginning of the research, the thesis set out six hypotheses to study and test. Of these, three were related to interest group theories: the revolving door hypothesis, the expert information hypothesis and the provision of information hypothesis. All three hypotheses have shown to have some effect as explanatory variables on the outcome, but were not the most critical in bringing about key de-regulatory outcomes. The thesis demonstrated that a revolving door at the level of elites in Washington D.C. and New York exists – which has also been extensively covered in academia. Nevertheless, these revolving doors did not cause the regulators to be caught by the industry, but to gain first-hand market insights. At the Fed, the door was not quite revolving, but mostly shut. The interviewed elites, including a current president of one of the Federal Reserve Banks, pointed out that the Fed has been the most careerist regulator in the US, with little movement between the industry and the Fed. The trading floors of the New York Federal Reserve allow the regulator to gather first-hand market experience as an active counterparty; it is thus far less dependent on outsiders' market knowledge.

The door at the SEC was in full swing between private law practices to the Commission and back – interviewees across all occupations and jurisdictions saw that as beneficial, as it allowed the Commission to remain up-to-date with market developments and gain a better overall understanding of market dynamics. The same could be said for the CFTC where commissioners have been largely recruited from the industry the CFTC has been regulating; but here again, it was hard to identify an element of capture or corruption, at least for the cases under consideration.

If Wall Street's lobby groups set out to capture or influence regulators via a revolving door, then they failed spectacularly at the Federal Reserve. They also had a limited impact at the SEC, which never appeared as an appellant alongside the SIA or the ICI during the lengthy court cases concerning Glass Steagall. However, the thesis shows that the expert information and provision of information hypotheses are key, not for capturing regulators, but for supplying them with up-to-date, often privileged market information that they would otherwise not have – with the exception of the Federal Reserve. It is important to bear in mind that regulators such as the CFTC and the SEC have an enormous amount of expertise in-house, but they lack the direct access to the trading floors as an active counter-party, and thus cannot judge the full impact of their regulation a priori. This is where industry feedback plays a key role such that (new) regulation minimises market turbulence and unintended negative consequences.

The judiciary

Institutionally safeguarded from interference by the executive and legislative powers, the US Supreme Court cannot be lobbied, is accessible to everyone via the judicial system and is transparent in its hearings and judgements. The judiciary as regulator hypothesis was tested in three Glass Steagall case studies. The first and the second Glass Steagall case studies – with the period under observation starting in the 1960s – showed that the US Supreme Court provided an interpretation of the Glass Steagall Act which was radically different in some respects to the conventional legal reading of the Act's separation between commercial and investment banking. It was the decision on ICI vs. Fed (Supreme Court of the United States, 1981) that set the ball rolling for the repeal of Glass Steagall: firstly, it moved the separating line between the two industries inside the Bank Holding Company, namely between legally separate affiliates (i.e. subsidiaries) of the same Holding Company; secondly, it re-affirmed the Federal Reserve's statutory authority to amend existing financial regulation, such as the Bank Holding Company Act or the Glass Steagall Act, as long as these amendments are "consistent with the language and legislative history" (Supreme Court of the United States, 1981); and thirdly, the Court provided guidance, but no hard limits, on the extent to which commercial banks could re-enter previously restricted investment banking activities, i.e. the definition was that the legally separate affiliate of the Bank Holding Companies was not to be "principally engaged in securities activities".

The court's decision was a watershed moment and clearly surprised the Fed, as the elite interviews demonstrated. Because the Court provided no clear definition for the thresholds of when an affiliate was principally engaged in investment banking, the commercial banking industry subsequently applied to re-enter investment banking, which would force the Federal Reserve to review their applications and ultimately provide and/or review a definition. In their applications, the banks had to explain their rationale and how they interpreted the term "principally engaged". The Federal Reserve then had to use its statutory authority to interpret these applications in the context of the US Court's ruling. The investment banking industry disagreed with the Fed's decisions and took legal action against them. As a result, the US Supreme Court heard a number of cases on Glass Steagall in the 1980s which established a body of case law that provided an ever more detailed interpretation of the Act and Congress's legislative intent.

As early as 1983, the Federal Reserve ruled that Bank of America, the second largest Bank Holding Company by assets in the United States, could acquire Charles Schwab, America's largest discount brokerage firm. By 1997, the Federal Reserve adopted an increase in the revenue limit in relation to the "principally engaged test" to 25%, which meant that a Bank Holding Company could essentially acquire most investment banks on Wall Street and still be below this threshold. The US Supreme Court agreed with both of these Fed rulings. Without legislative change, the courts are one of the few institutions that not only police the rules of the game, but have the power to interpret them to the extent that these rules can take a very different meaning from their original intent.

The blocking of the Trump administration's proposed immigration policy (or better referred to as a travel ban) for seven Muslim-majority countries by US Federal courts serves as a very recent reminder of how independent and powerful the US judiciary is.

The role of ideas

The role of ideas hypothesis and its explanatory variable has been key in all cases, except the first Glass Steagall case study. Since the end of the 1970s, the idea in efficient markets that are best left as unregulated as possible has taken the US investment banking community as well as its regulators by storm. People's ideas about the appropriate level of regulation has been a crucial factor in the Fed's change of tack under Volcker to Greenspan in the 1980s, during which time market liberal ideas won the upper hand so much that pro-regulation research and ideas would not even get elevated to the top (ML, 2010). Greenspan's depiction in recent biographies, such as Mallaby's *The Man Who Knew: The Life and Times of Alan Greenspan,* as a savvy political player at the Federal Reserve, underestimate how much libertarian and free market ideas guided Greenspan throughout his entire career (Mallaby 2016). In his own words: "can trade and standards of living continue to increase indefinitely? Yes. That is the gift of competitive free markets and the irreversible accumulation of technology" (Greenspan 2008).

At the SEC, the power of ideas clearly manifested itself in the Division of Market Regulation, changing its name to the Division of Markets and Trading, as one would otherwise "start meetings on the back foot in Washington D.C." (CR, 2010) whilst at the policy level, SEC staff believed in the superiority of the Basel approach and its use of Value at Risk (VaR) models. It was regarded as state-of-the-art-risk management. Over at the CFTC, the commission, with the exception of the years under Chairperson Brooksley Born, was so convinced of the power of markets' efficient self-regulation that Swap OTC derivatives were largely exempted from regulation, a fact that was later passed into a law, the Commodities Futures Modernisation Act of 2000 (CFMA 2000). CFMA 2000 is one of the most remarkable episodes in the history of US financial regulation: all American financial regulators, both parties in Congress and the Clinton administration agreed to make the regulation of OTC derivatives illegal. Backed by an ideational consensus that spanned party lines, lobby groups and businesses, it was one of the rare moments where a bipartisan majority in Washington not only unanimously agreed not to regulate, but also to prevent future regulation by law.

Regulators' statutory authority

Last but not least, the statutory authority hypothesis has been a further important explanatory variable that has been relevant in all case studies. In the repeal of Glass Steagall chapters, the Federal Reserve used its statutory authority to carefully enact amendments to existing regulations which it believed to be within the legislative intent of the law. Because it acted within its statutory authority, the investment banking industry challenged the Fed's rule changes in the courts, but consistently lost. The Fed under Greenspan made extensive use of its statutory authority in order to blur and later on erase the separating line between commercial and investment banking. As such, it brought about significant regulatory change without Congress passing any new laws. In other words, it filled the vacuum of Congress's impasse. The CFTC case study is a very interesting case for testing the hypothesis, as the CFTC gained statutory authority from Congress in 1992 for exempting OTC derivatives swaps from regulation during the period of observation of the case study. Before 1992, legal uncertainties existed as to whether forwards would be classified as futures and thus lose their exemption from regulation. Because the CFTC lacked the statutory authority to amend the regulatory regime to bring about this reduction in regulation, or non-regulation, it could only issue a statement saying that it would not classify forwards as futures. However, a court defined forwards as futures shortly after the release of the statement which put all forward transactions in jeopardy, as they would be illegal and as such unenforceable. When the CFTC gained statutory authority over the OTC derivatives markets regulation in 1992, it could nevertheless not make use of it as the Commission had pitched itself against the entire US regulatory community, Treasury and markets. What it shows is that for statutory authority to be effective, the regulator needs to act within the ideational consensus at the time, or gather at least a good proportion of key policymakers and opinion leaders behind its position. In case it lacks statutory authority, but is broadly in line with the ideational consensus, its regime is still open and vulnerable to legal action, as the CFTC example pre 1993 shows. Analysing the SEC's consolidated regimes of supervision is interesting, as they seem to fit a similar pattern: the SEC's Supervised Investment Bank Holding Company regime from the Gramm Leach Bliley act was purely voluntary, and at the time not congruent with the ideational consensus of the investment banking industry, which did not want consolidated supervision. The tables turned with the European Union's Financial Conglomerates regime. The SEC established the CSE Programme, also without statutory authority, but this time it was in line with the ideational consensus, meaning that all top investment banks signed up for it.

9.3 FINDINGS FROM THE CASE STUDIES

Glass Steagall

The repeal of Glass Steagall started in 1981 with a US Supreme Court interpretation about the legislative intent of Glass Steagall that became a landmark ruling, and set in motion a chain of events that culminated with the repeal of Glass Steagall, the Gramm Leach Bliley Act. This ruling was itself the accumulation of a near decade-long, protracted legal battle between the Investment Company Institute and the Federal Reserve. As was discussed earlier, the judiciary brought about regulatory change without legislative change. This was a rather unique situation, but deserves a greater audience in the IPE literature since political deadlocks in parliament are not unusual, and it shows one of the ways courts can and will 'step up' and fill the vacuum. Overall, then, all three Glass Steagall cases show that the repeal of Glass Steagall was not driven by US investment banks. On the contrary, they were the ones trying to uphold the separating line between commercial and investment banking. At the same time, commercial banks' impetus to enter the highly profitable area of investment banking at a time when commercial banks' core business – namely commercial and retail banking – was barely profitable was also in the interest of the Federal Reserve. Profitable banks are stable banks. However, the Supreme Court's ruling and the Fed's subsequent regulatory amendments with respect to section 20 subsidiaries hollowed out the separating line to an extent that despite Glass Steagall still being in place, US Bank Holding Companies could legally acquire entire US investment banks. The Federal Reserve, especially under Alan Greenspan, used its statutory authority extensively to bring about regulatory change without legislative change. As Greenspan's first testimony as Chairman of the Federal Reserve in front of Congress highlighted: he provided a schedule of things to come, i.e. if Congress did not manage to repeal Glass Steagall, which was the preferred route, he essentially would have to work towards it, yet in a piecemeal fashion. Greenspan swept the Fed, within months of taking office, with his ardent belief in the superiority and efficiency of markets. The role of ideas about the appropriate regulatory regime – i.e. market-based regulation – plays an important role in the repeal of Glass Steagall. It provided Greenspan with the intellectual justification for pushing through regulatory change by way of using the Federal Reserve's statutory authority. As such, it adds a further dimension to the role of regulators as institutions that not only enforce the rules of the game, but can actually rewrite them. In sum, the repeal of Glass Steagall was a clear deregulatory event, however not an outcome the investment banks, but rather the commercial banks had pushed or wished for.

CFTC

The CFTC case study represents a somewhat extreme case of de-regulation, namely that of intentional non-regulation guaranteed by law. The case study investigated the causes that led to the passage of the Commodity Futures Modernisation Act of 2000 (CMFA). It is the only case study where the regulator received statutory authority during the period of observation through Congress's passing of the Futures Trading Practises Act in 1992. The development of US swaps OTC derivatives was clearly very important to the CFTC, so much so that it issued its Swap Policy Statement in which it clarified that it would not classify certain OTC derivatives as futures, and thus exempt them from regulation. The CFTC tried to calm market fears that regulation was looming, thereby declaring many OTC instruments as illegal and unenforceable. Because the CFTC lacked statutory authority, it could not prevent the US courts from essentially ruling against its own Swap Policy Statement. This episode highlighted that if regulators move outside their statutory authority, they expose themselves to being challenged in the courts even if they are aligned with the ideational consensus of the market participants and other regulators. However, statutory authority alone is also not sufficient: the CFTC was within its statutory authority to issue the Concept Release, and the regulator also had authority to amend the relevant swaps exemptions if it so wished. The CFTC story surrounding Brooksley Born highlighted the sensitivities regulators have to navigate in order to achieve successful policy outcomes. In the case of the concept release, Born was warned to go about it in a softer way, but she ignored the President Working Group's plea. When the release was published, she had an uphill battle in Congress, only made worse by her belligerent style in testimonies. In the end, the CFTC attempted to go it alone against the ideational consensus of the entire regulatory policy community as well as the industry. Despite having the authority to do so in theory, it failed in practice. The fear that hundreds of billions of dollars of OTC derivatives swaps and forwards could be declared as on-exchange futures, coupled with people's belief in leaving these markets unregulated so as to not drive them offshore and diminish their innovative power, sealed Born's fate. The CFTC and Born were acting within their statutory authority, but outside the policy consensus. They both failed.

The SEC's net capital rule

The SEC's alternative net capital rule and Consolidated Supervised Entity Programme was, contrary to conventional belief amongst journalists and academics alike, not the result of investment banks' successful lobbying, but the direct result of the European process of capital markets integration. The European Union's Financial Conglomerate's Directive required that all financial conglomerates active in the EU be supervised on a consolidated basis. In case of non-EU third party financial conglomerates, the third countries had to either offer a regime of consolidated supervision that was judged to be equivalent to the EU's, or else its financial conglomerates would be required to establish a European Union-based and separately capitalised holding company. The SEC programme is an interesting case study in two major aspects: firstly, the SEC could not be proactive, but also could only be reactive. As such, the creation of the CSE programme was driven neither by US investment banks nor the SEC, but by European officials, who wanted not only to harmonise regulatory regimes across the EU member countries, but establish a single market. The SEC successfully achieved equivalence status with its voluntary supervisory regime. Whilst it had no statutory authority to require investment banks to join, it nevertheless achieved the signing up of all large US investment banks. Secondly, the alternative net capital rule led to a reduction in capital, which was seen not only by the SEC, but by the wider regulatory community as 'state of the art' given its incorporation of Basel standards. Again, an ideational consensus about what is the 'best' capital standard was an important factor. The deregulatory factor was thus the alternative net capital, which led to a decrease in investment bank's capital. This was seen as appropriate since the investment banks were also subject to more stringent reporting and were supervised on a consolidated basis. However, it was not investment banks pushing for this; it emanated as a side product from the process of European financial market integration. US investment banks were opposed to consolidated supervision both in the EU as well as the US, as it meant that their holding companies would have to comply with much more onerous and stringent reporting and governance requirements, whereas previously it was only their US or EU affiliates that had to answer to the SEC or the local EU regulators.

9.4 CROSS COMPARISONS, THEORY-BUILDING & FUTURE RESEARCH

When comparing all these episodes of deregulation across the other cases, it becomes clear that the thesis's interest group explanatory variables and hypotheses were the least powerful. Industry associations did have privileged access and provided key information to regulators, but this was only relevant at the margins. Besides, a lot of this information was given via public consultation periods. The same applies for the revolving door – the movements between the Fed and the banks it regulates were very limited. In the SEC, commissioners might move from the SEC to private law practice, but this did not translate to people receiving preferential treatment or other pay-offs. Overall, the thesis did not find evidence that the revolving door was of great importance in bringing about the specific deregulatory actions, and it found no evidence of individuals influencing regulatory decisions to receive personal gains when moving into the private sector.

The role of ideas is an explanatory variable that is notoriously difficult to measure, especially quantitatively. However, the thesis's process tracing through thousands of documents combined with elite interviews allowed the author to establish a detailed corpus of work that could shine light on the ideological biases of the key decision-makers at the time. Without being able to quantify "how much", the dissertation revealed that ideas do play a key role in essentially all but one of the case studies: the very first case study on the beginnings of the repeal of Glass Steagall dates back to the 1960s, which made it difficult to interview key elites of the time and determine their ideational mindset. As to the other cases, semi-structured elite interviews together with statements made to the media and hearings in front of Congress are key data sources to unearth that ideas matter. Alan Greenspan's House and Senate hearings and his books alone provide clear evidence in his belief in the superiority of the free markets; supplementing this data with interview material enabled the author to establish chains of causality within which people's ideas about regulation mattered. As such, ideas played an important role in these case studies, especially in determining the direction of regulatory change, i.e. deregulatory or not.

The role of the judiciary as an actor whose interpretative rulings can mimic those of the legislative and cause significant regulatory change without legislative change is an important addition to the study of the IPE of finance, and warrants further analysis in other episodes where courts were asked to step in. One area that springs to mind is labour law. Even though dispute settlement mechanisms are a well-researched topic in the IPE of trade, the judiciary is one of the most under-researched actors and aspects in political science and the wider IPE. Both the judiciary's workings and the complex interplays between the courts and regulators are not well understood. People tend to forget that one of the key moments for the survival of the Euro during the financial crisis of 2007 and beyond was a decision by Germany's highest court, the Federal Constitutional Court, that Germany's participation in the European Stability Mechanism (which provides financial assistance to Eurozone member states in distress and has an approved lending capacity of EUR500bn) was compatible with Germany's Basic Law. Had the court decided otherwise on September 12th 2012, it could have caused the collapse of the Euro, as many politicians and economists had warned.

A matrix

It is worth developing the concept and conditions of success of statutory authority a bit more and beyond the remit of the IPE of investment banking. It was relevant across all case studies. The thesis argues that the success or failure of regulatory outcomes can be depicted in a two-by-three matrix. On one of the axes, you have statutory authority – either as a yes or no. On the other axis, you have ideational consensus with three possible categories: in full alignment with ideational consensus, in alignment with a few key actors, no alignment. Cases where regulators have statutory authority and are in full alignment with the ideational consensus will lead to positive regulatory outcomes. The CFTC after the departure of Born is an example.

If the regulator has statutory authority, but only the support of some key constituents, then this can still lead to successful policy outcomes, as the case study of the Fed and Glass Steagall demonstrates. The Fed acted within its statutory authority, but was not in full alignment with all actors since the investment banking community was vehemently opposed, whilst commercial banks supported it. What followed was a piecemeal hollowing out of Glass Steagall which took more than two decades.

Finally, if regulators have statutory authority, but are not at all aligned with the ideational policy consensus, they risk failing, as can be seen with the CFTC under Born. On the other side of the matrix, if regulators lack statutory authority, but amend rules that are in full alignment with the ideational consensus, they could be successful if they do not get challenged in the courts; examples here are the CFTC Swap Policy Statement or the SEC's CSE Programme.

However, if regulators lack statutory authority and are not in tune with the ideational consensus, then they will not manage to bring about their regulatory policy outcomes; an example here would be the SEC's Supervised Investment Bank Holding Company regime.

Key learnings

Having researched more than five decades of investment banking regulation and the politics thereof, it is clear that commercial banks should not have been allowed to re-enter investment banking. Many commercial banks used their customers' deposits in order to trade and invest in investment banking markets. When the sub-prime mortgage crisis hit, the majority of the world's top commercial banks had to be bailed out, as these banks played a key role in their respective economies and it would have caused a melt-down in the world's financial system if clients had lost their assets. Because of the maturity transformation and the banks' role in providing credit, and thereby creating money for the economy, they should simply be firewalled from being active in investment banking.

As for the investment banks, they play a key role in financial innovation: sub-prime mortgages and the securitisation of sub-prime mortgages are both Wall Street inventions. It allowed previously under-banked and financially disadvantaged US citizens to gain a foothold in the US housing market (with all its benefits as well as pitfalls) which is vital to gain better job prospects and improve one's credit score. Securitising these mortgages enabled investors to spread and disperse the risks. Both of these aspects in isolation were good things. However, investment banks and investment banking markets – in which both commercial and investment banks operated – needed more stringent, macro-prudential supervision by the SEC and the Fed. Neither of these two regulators identified sub-prime mortgages as big problem. Moreover, if investment banks were still owned by their partners (as was the case historically) who would also be fully and personally liable for any losses suffered by their investment bank, then we would have probably seen less risk-taking behaviour. Goldman Sachs was a private partnership until they went public in 1999.

A final key learning is that investment banks and investment banking markets have become so large and intertwined with commercial banking that the liquidation of an investment bank, such as Lehman Brothers, caused huge shock waves around the globe since Lehman Brothers was essentially systemically relevant. The only remedy is that bigger is not better, but the opposite: regulators should be wary of large investment banks. Even if they are not commercial banks and a part of the economy's money creation and money supply circle, their market positions can be so important that they end up creating huge shock waves in case of failure. Nota bene, this did not happen when Drexel Burnahm Lambert collapsed in 1990.

Overall then, commercial banks should not be active in investment banking and investment bankers should be asked to participate in the bail outs their bank in bad times. Both of these remedies would have provided very different incentive structures for bankers in both fields.

Developments since 2007 & future recommendations

The thesis shed light on the various actors and events that drove de-regulatory decision-making – some of which were surprising – and the role of the investment banks within it. Whilst clearly being an important financial sector, it could not stop the repeal of Glass Steagall or the establishment of the CSE Programme. As the crisis which started in 2007 is still unfolding in Europe, in the Italian and German banking system, in the overall health of the Greek economy, there is ample opportunity to build on this dissertation's findings to unearth and examine further root causes of de-regulatory decision-making and its consequences.

The dissertation focussed on the IPE of financial regulation of investment banking, but the cases have much wider applicability: firstly, the role of the judiciary in regulatory decision-making and the politics of finance is poorly understood and requires a more substantive examination in future research. The Glass Steagall case studies were very clear instances where the judiciary played a key role.

Likewise, lobbying in the form of financial contributions certainly impacts the legislative, especially in the United States. However, the inner workings of US financial regulators need better academic scrutiny and research, as lobbying takes a very different form here. Instead of money, lobbying regulators is centred around information. Researchers should not underestimate the negative consequences from information asymmetries and scenarios of imperfect information. The very fact that investors did not know whether OTC derivatives could be classified as on-exchange products in the US made them leave in droves to the European trading markets. Information asymmetries have been extensively studied in economics; there are still gaps in the IPE of finance literature.

The Italian state and the EU finally agreed on a bailout of two Italian banks – Veneto Banca and Banca Popolare di Vicenza – for up to EUR17bn on June 26th, 2017, nearly a decade after the sub-prime mortgage crisis began and the bank run on the United Kingdom's Northern Rock bank. This sub-prime mortgage crisis led to the collapse of Lehman Brothers, the fire sale of Bear Stearns and Merrill Lynch and caused Morgan Stanley and Goldman Sachs to change their legal structure into Bank Holding Companies and become Fed regulated in order to access the discount window and calm investors' worries. The big, SEC regulated US investment banks, which could be put into liquidation without causing market havoc, have all but disappeared.

This is a big worry. Investment banks should, by their very structure, neither have access to a discount window nor have a lender of last resort. They are not deposit- taking institutions like commercial banks and do not need to be able to access central bank money for solvency or liquidity reasons. Goldman, Sachs and Morgan Stanley switched from being SEC regulated inter-broker dealers to bank holding companies, i.e. a Federal Reserve regulated commercial banks, on September 21st, 2008. This move assured markets and investors that both Goldman and Morgan Stanley would by default remain liquid because of their access to the discount window. It should have been a temporary and not a permanent measure as both investment banks benefit from tax- payer funding and central bank liquidity, despite running two of the largest investment banking operations world-wide.

Moreover, investment banks are inter-broker dealers, i.e. intermediaries that invest and trade money on behalf of their clients, but not clients' money on behalf of themselves. Investment banks have been extremely entrepreneurial and innovative forces in financial markets which has created enormous value (as well as risks) for clients and societies at large – derivatives, asset backed securities, equity linked products are just a few of the inventions that help businesses better manage their risk and cash flows. However, what has happened since 2008 has been a deterioration in the classic business of investment banks which has undermined innovation. At the same time, quantitative easing combined with a low interest environment has made it very challenging for commercial banks to remain profitable (above their cost of capital). Legislative attempts for US financial regulatory reform since 2008 have produced the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) which was passed in 2010. A literature research in key IPE journals on Dodd-Frank reveals that little has been published to date. Dodd-Frank is an extremely complex Act encompassing elements that involve all financial regulators in the US and issue areas ranging from executive pay and corporate governance to credit rating agencies to state-based insurance reform. It goes beyond the scope of this chapter to examine Dodd-Frank and its consequences. However, what can be said is that we live in a very precarious situation where it is not clear how banks and financial markets will react to central banks retracting from years of quantitative easing. Neither the EU nor the US have taken steps to fully disentangle commercial banking from investment banking. It has taken European banks, especially Italian banks, ten years to recognise their losses, establish bad banks and repair their balance sheets. It would be a scandal for the taxpayer, regulators and politicians alike if these banks were to engage in risky banking activities again as soon as they emerge from the last crisis.

Hans Trees
SGIA, Durham University

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